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FEDERAL LEASING PRACTICES

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

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FEDERAL LEASING PRACTICES

MONDAY, FEBRUARY 28, 1983

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Charles B. Rangel (chairman of the subcommittee) presiding.

[Press release announcing the hearing follows:]

[Press Release, Feb. 10, 1983]

HON. CHARLES B. RANGEL, CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, ANNOUNCES A HEARING ON THE IMPACT OF FEDERAL LEASING PRACTICES

The Honorable Charles B. Rangel (D., N.Y.), Chairman of the Oversight Subcommittee, Committee on Ways and Means, today announced a hearing to examine recent Federal contract leasing practices. This hearing is part of the Subcommittee's review of leasing as a means of public finance. The Subcommittee hearing will be held on Monday, February 28, 1983, in Room 1100 of the Longworth House Office Building, beginning at 10:00 a.m.

The Subcommittee will review the Navy's recent decision to award a $2.39 billion contract to build and charter 13 ships under a long-term lease as well as other major leasing transactions under consideration by the Federal government.

The hearing will also examine (a) the extent of Federal revenue loss resulting from tax benefits available to private firms entering into such transactions with the Federal government, (b) whether revenue effects have been considered by agencies contemplating such transactions, and (c) whether Federal agency use of leveraged leasing, in effect, circumvents the Congressional budget, authorizations, and appropriations process.

Witnesses invited to appear at the hearing will include representatives from the Department of the Treasury, the Department of Defense, the Navy, the Air Force, the Office of Management and Budget, the General Services Administration, and the General Accounting Office.

Chairman RANGEL. The Subcommittee on Oversight of the Committee on Ways and Means will come to order.

Leasing is an established method of financing the acquisition of certain types of property in the private sector. The reasons for leasing stem from tax, accounting, and a variety of business considerations. Governmental units and tax-exempt organizations also lease certain types of property for many of the same reasons as taxable private sector firms.

When Government agencies or other nontaxable entities lease property they might have purchased, Federal income tax benefits are generated for the lessor/property owner. Most of these tax benefits may be passed through to the entity as reduced rents.

Therefore, part of the cost of the asset may be shifted from the organization's budget to the Treasury.

The purpose of the subcommittee hearing today is to obtain information on leasing practices by the Federal Government and to examine related tax and budget policy issues. Our initial focus is the Department of the Navy's decision to lease 13 ships and other major leasing transactions under consideration by Federal agencies.

The Navy transaction involves the lease/charter of 13 ships designed to provide sealift support for U.S. rapid deployment forces. It is not the subcommittee's intention, nor is it our responsibility, to pass judgment on the Navy's need for these ships. The subcommittee's principal concerns are the tax and budget policy issues that arise from Government lease/charter transactions. In this regard, the Navy agreements are case examples for study. I want to thank the Navy for its cooperation in providing the subcommittee with documents concerning the agreements.

At the request of the subcommittee, the staff of the Joint Committee on Taxation has analyzed one of the Navy contracts. Analysis of the agreement indicates that the Navy will save an estimated $37 million in onbudget expenditures from the $178.2 million purchase price of the ship.

However, the Treasury will lose approximately $58.7 million arising from tax benefits available to the ship's owner. Thus, the total cost to the Government of leasing just 1 ship is $199 million, $20.8 million, or about 12 percent more than direct purchase. In total, leasing all 13 ships will cost the Government an additional $270 million.

To the extent other Federal departments plan increased use of leasing to obtain property, a number of critical questions must be examined, such as:

The cost of leasing to the Government as compared to outright purchases, including the revenue loss to the Treasury;

The impact of increased leasing activity on the Federal budget and whether such transactions are accounted for properly in the budget;

The extent to which procurement policy and the structure of leasing transactions are being influenced by tax laws and whether lessors who lease property to the Federal Government receive unintended tax benefits; and

Whether agency leasing proposals receive adequate administration and/or congressional review.

Many of these questions reflect appropriate Federal concerns regarding increased leasing activity by State and local governments and other nontaxable entities.

Witnesses from the Department of Defense, the Navy, the Air Force, the Treasury Department, the Office of Management and Budget, the General Services Administration, and the General Accounting Office have been invited to address these issues.

At this time, I will recognize members of the subcommittee who wish to make opening statements.

Mr. Pickle?

Mr. PICKLE. Mr. Chairman, I thank you, and I appreciate the committee's help and support in scheduling this hearing this morning.

I want to make an opening statement, and it may be a little longer than usual, but I wish to put in prospective the statements that the chairman has made and overview of some of the matters.

I will make it as quick as I can. Senator Metzenbaum is here and has another issue before him in the Senate.

Mr. Chairman, I appreciate the committee's help and support in scheduling this hearing on the issue of leveraged leasing and its relationship to public finance.

Recent changes in the tax law—ERTA and TEFRA—have made it more attractive than ever to lease rather than purchase. This is true, we are discovering, for the public sector as well as the private sector. Our own Ways and Means Committee has been a party to this development. As a result, we are beginning to see municipal governments, for example, lease waste-water treatment plants and even city halls, rather than fund these community functions and facilities by traditional means.

There are reports of leveraged leasing arrangements being used to finance major electrical generation projects around the country. And, now, in November 1982, the U.S. Navy announced that it had awarded contracts for the tax leasing of 13 new cargo ships and 5 new tankers worth some $3 billion.

The need for a closer look at the Navy's decision to lease and its implications, in terms of other leasing activities on the State, local, and Federal level, has brought us here today.

At the request of the subcommittee, the Joint Tax Committee staff has made an in-depth study, an excellent analysis of the Navy's lease of the 13 TAKX cargo ships. This is not an inquiry to say that the Navy has violated a law or been involved in some kind of unfair schemes.

There is no indication that we are trying to fault the Navy, as such.

The results of the Joint Tax Committee's report are summarized in the accompanying chart prepared at my request by the House Information Service. An independent economic analysis of the TAKX lease undertaken by the Congressional Research Service has confirmed the major findings of the Joint Tax Committee staff.

Perhaps it would be worthwhile to take a quick look at the numbers here in order to appreciate the magnitude of the issue and perhaps get a glimpse of the implications for national tax and budget policy.

If you can't see them, let me tell the audience what they show.

In terms of total cost to the Federal Government, leasing costs more than purchasing—in the case of the TAKX cargo ships, 10 percent to 12 percent more.

It is true that the Navy comes out ahead. On a single ship, the Navy's cost drops from $178.2 million to $141.2 million for a $37 million savings per ship. But the cost to the Government goes, as you can see, from $178.2 million to $199 million, $20.8 million more as a result of leasing. For the 13 TAKX vessels this amounts to an extra cost to the Government of roughly $270 million.

More important, however, than the increased cost, is the fact that in the course of the leasing transaction the Navy very adroitly shifts $57.8 million, or about 30 percent, of the cost of the lease from its budget to that of the Department of Treasury.

In other words, the leasing of the 13 ships increases the cost to the Government some 10 to 12 percent—$270 million—and at the same time shifts approximately 30 percent of the cost of the ship—about $750 million for all 13 ships—from the Navy's budget to the Treasury's budget in the form of lost tax revenues.

The Navy's leasing deal, it seems to me, is important not just because it costs the Government more money or even because it allows the Navy to shift a significant portion of its cost off to the Treasury. These facts certainly warrant the attention of the Congress and probably justify strong legislative action to prevent this kind of thing from happening without thorough congressional consideration in the future.

The real importance of the Navy transaction, however, is the fact that, as large as it is and as many millions of dollars as it involves, it is really only representative of a much larger issue, and that is the fact that leveraged leasing is rapidly emerging as the financing option of choice for public entities.

If the Navy, by means of leveraged leasing, is able to shift 30 percent of the cost of these vessels to the tax expenditure budget, then what portion of State and local leveraged leasing is Treasury picking up? This new practice raises all sorts of national policy issues.

First, there are the tax issues. Leasing is obviously cheaper than purchasing for the governmental entity because much of the cost is passed along to Uncle Sam in the form of tax loss. This is the hidden cost of the leasing transaction.

I would ask the Treasury to what extent is this taking place? Do our national budgeting techniques account for this loss in revenue?

It seems to me that by providing cities and States tax incentives for leveraged leasing, we are engaging in a kind of back door revenue sharing. Is this an efficient way to provide a Federal subsidy, or is there really much left after all the attorneys' fees and financing charges?

Second, from a budget policy standpoint, leveraged leasing shifts funds from a department's procurement account to its operating and maintenance account, and from the department's budget to the tax expenditure budget of the Treasury. In the process, long-term commitments, the incontrollable costs of the future, are built into Federal, State, and local budgets.

Third, there's the defense issue, and that is not my prerogative, but it has to be mentioned in these hearings.

In the case of the TAKX cargo ships, we can see military policy being dictated by tax policy as long-term leases are structured as service contracts in order to take advantage of investment tax credits.

Fourth, is the issue of providing an investor of a tax break on top of a governmental guarantee of return. As the Navy leases are structured, the lessor assumes virtually no risk. Fluctuations in interest rates, labor and fuel costs, insurance, and even tax breaks are guaranteed. The full faith and credit of the U.S. Government

warrants that the investor will get a fat 14-percent after-tax return on his money.

Fifth, there is the question of who is responsible for managing the asset and whether it will, in fact, be managed in the public's best interest. What happens if something goes wrong? If the ship is sunk, or the waste-water treatment plant cannot be maintained at the contract rate, who accepts responsibility? Does it simply lead to extended litigation and neglect of the public interest?

Sixth, at the local level, or even at the Federal agency level, as we have seen, there is the matter of adequate public oversight and participation in the decision to lease. Where the issuance of municipal bonds is concerned, the law requires that an election be held and that the people be given a chance to participate—to approve or disapprove the purchase of the asset.

This opportunity does not exist, or hardly exists, in the case of lease financing. In fact, a decision to commit long-term moneys is often made with no public debate and no clear idea of the total cost involved.

These are the issues, Mr. Chairman, that should be the subject of our attention today.

We must have these issues before us as we proceed, and I appreciate the chairman yielding to me.

Mr. Duncan?

Mr. DUNCAN. I had not planned any opening statement, but I would like to compliment you on calling the hearings. I have always been concerned about leasing, not particularly by the Navy, and I understand what perhaps prompted the hearings today, and, why the Navy and the military has been singled out. But I have always been more concerned with the Postal Department throughout the years on this. It is something that has not just started in recent years, but has been going on for years and years by the paying of high rentals, which the country could have been better off had the buildings been purchased outright.

I think that we should, Mr. Chairman, not only have witnesses from the military, but also from the Postal Department and go into this thing more completely. Many of our major cities are moving in and renting and leasing properties with tax consequences to the owner of the property, the lessor. It is certainly a tax advantage to many, but we can't just stop with the military and say that is it.

Thank you, Mr. Chairman.

Chairman RANGEL. Thank you.

Mr. Dorgan.

Mr. DORGAN. I am most anxious to hear the Senator, but I, too, wish to compliment you for calling the hearing. Having worked in the tax field, myself, and dealt with the acronyms of taxation, ITC, and so on, I have often thought there should be an acronym, UR; that is, unintended result.

Much of what we intend is to stimulate production by providing tax incentives. But often we only produce unintended results. This is an example of a distorted unintended result of the tax system.

It is a case where looking at the tax system, using ACRS, ITC's, and so on, that the unintended result here is that the taxpayer will pay more, while the Navy thinks it is paying less.

The question is, who authorized it? Isn't this biting the hands that feed you, and is this what we really ought to be doing?

I think the answer is no. This is the kind of forum to explore why this happens and the lessons from this hearing, I hope, will be not only what do these tax laws, including ACRS, for example, mean for these kinds of transactions that the Navy has involved themselves in, but isn't this an example of why ACRS was oversold and why it needs desperately to be revised for general tax purposes?

But I am most anxious to hear Senator Metzenbaum.

Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Martin?

Mr. MARTIN. I, too, want to welcome Senator Metzenbaum and all of the other witnesses who will be here. We are, of course, interested in determining the extent to which these leasing transactions are either beneficial or disadvantageous to the Government. Until we get a full record set forth for our consideration, we have only news accounts, some of which indicate we come out even better, and others that indicate we come out substantially worse.

Our purpose on this subcommittee is to determine what the truth of the matter is, what the parameters are, how they arrive at these calculations, and see to it that the full effects of the tax benefits are taken into account, so that the full cost to the Government, not only the direct cost of the monthly, annual lease payments, but also the revenue losses are measurable, and are accounted to the ledger on the side of either the Defense Department or any other nontaxed entity that may be taking advantage of these kinds of devices. We welcome your testimony and look forward to it.

Chairman RANGEL. Let me say that, Mr. Martin, your concerns are consistent with the concerns that have been expressed by other members of the subcommittee.

Our first witness is the Honorable Howard Metzenbaum. Senator, let me thank you for taking the time to testify this morning. We know you have a busy legislative agenda in the other body, but we are interested in your comments and testimony. You may proceed with your testimony in any manner in which you feel most comfortable.

STATEMENT OF HON. HOWARD M. METZENBAUM, A U.S. SENATOR FROM THE STATE OF OHIO

Senator METZENBAUM. I would like to commend you and Congressman Pickle, Congressman Dorgan, Mr. Duncan, and Mr. Martin for taking the time to explore this subject today.

It is a particularly interesting one, because it not only has to do with matters of dollars, but with the integrity and credibility of our governmental process. So, I am pleased to appear here before this oversight subcommittee, and I want to make it clear at the inception that the issue before us, Mr. Chairman, has nothing to do with whether or not the Navy has a legitimate requirement for cargo ships.

Of course, they have such a legitimate need, and I do not in any way question their need for the ships. Our focus is upon the method used by the Navy to acquire these ships, and, frankly, in

our opinion, as a member of the Budget Committee, I feel very strongly that it circumvents the budget and the appropriations process as well.

It imposes substantial extra costs upon the taxpayer, that is the critical question, and it jeopardizes the future readiness of our naval forces by converting the operations and maintenance budget into a procurement account. That is a point that is irrefutable.

The Navy, Mr. Chairman, has determined that 13 cargo ships are required to support the Rapid Deployment Force. The ships could be purchased at a cost of $184 million apiece.

Instead of buying the ships, however, the Navy chose to take another route—to contract for the construction of the vessels and then rent them for a 5-year period with an option to extend the lease for up to 25 years.

What does this mean?

In dollars, it will mean a cost to the taxpayer of $415 million per ship over the term of the lease. That figure is for the ship only—it does not include the costs of personnel, maintenance, and operations.

The Joint Tax Committee has come up with one figure, and the facts are that it depends a little bit on whether or not you figure the value of the money today, and in what tax bracket you believe the lessors and the banks would be. I believe the costs would be higher than some of the figures that have heretofore been indicated by the Joint Tax Committee; but I am not here to question the exact number of dollars, because all agree that it will cost the Government more if they lease.

The Navy, under this arrangement, bears the financial risk in the event that any of the vessels are destroyed in wartime.

The Navy bears sole responsibility for future increases in fuel costs, wages, insurance, and other operational expenses.

And if the Navy decides not to renew any of its 5-year options for a ship, the taxpayers of this country are obligated to pay to the owners an amount equal to the fair-market value of the vessel in question. There would be no arrangement to find that money unless you took it from the O&M account.

And this, Mr. Chairman, is only the tip of the iceberg.

I have cited a direct-cost figure of $415 million per ship over the term of the lease.

But there are other costs—indirect costs—that very substantially increase the price that we, the public, will be required to pay. That is so because with this leasing arrangement, the U.S. Navy has gone into the business of selling tax shelters.

Since they are constructing these ships for lease, not sale, the shipowners intend to take an investment tax credit and depreciation deductions for the first 5 years—nothing illegal about it; entirely appropriate. They plan also to deduct any interest they pay on bonds used to finance the construction. And, according to a Navy study, these tax writeoffs could cost the Treasury $210 million per ship over the 25-year lease term.

I want to point out that $220 million figure is according to a study that the Navy, itself, had done. I think it is called the Argent study.

That is fine with the Navy. The money does not come from their budget. But the money does come from the Federal Treasury in the form of taxes never paid. And, in the end, it is money that will have to be made up by taxpayers who do not enjoy the benefit of these enormous writeoffs.

I might say parenthetically that in one letter that the Secretary of the Navy sent to either Senator John Tower or to Senator Hatfield, he pointed out that the tax deductions need not really be taken into account, because, if the companies did not use those, they would find some other ways of getting similar tax deductions. This is a rather absurd position for the Secretary of the Navy to be taking.

I have already stated that it will cost more to lease than to buy these ships. But these deals are also bad in terms of their implication on the budget and appropriations process.

Congress has the responsibility for deciding how much money the Navy has to purchase weapons, and how much it has in order to maintain them in good working order. But the Navy, by this procedure, will be scuttling the congressional budget and appropriations process.

The $415 million per ship will not come out of the Navy's procurement budget, as would ordinarily be the case in the purchase of a weapon or ship. Instead, it will come out of the Navy's operations and maintenance account—the very money which the Navy has asked Congress for in order to keep its planes flying, its ships sailing, and its weapons firing.

In effect, the Navy is robbing its operations and maintenance accounts to increase the size of its fleet.

If Congress does not address this issue now, we will soon lose control over military spending and permit the Department of Defense to decide its own procurement budget. One morning we will wake up and find in the morning papers that the MX missile has just been leased out of operations and maintenance funds; that an aircraft carrier that Congress has excluded from the procurement budget is now sailing with the U.S. Navy as a rented vessel; or that the President has landed at Andrews Air Force Base in a rented Air Force One.

Of course, the examples I use are somewhat absurd on their face, but the fact is that the Air Force is considering leasing, and I don't think there is any doubt that unless Congress indicates that it is not in accordance with our will, this is but the forerunner of the general practice along the same line.

And with whom is the Navy contracting?

The Department of Navy is signing contracts with dummy corporations which have as little as $100 in capital. In fact, these companies were incorporated in Delaware just a short time before the contracts were signed. Frankly, Mr. Chairman, I am not certain why these contracts were signed with dummy corporations, but I believe that there are serious implications to such a practice. For example, what recourse does the Navy have if the ships are not delivered on time, if they have defects, or if they are destroyed before delivery? I have a chart over here that I would like to show you.

First, we have here the Navy leasing from the dummy corporation, and under the contract it provides that there will be certain

partners in the deal, but the partners are not even named. There is no way of even knowing who they are. They are as yet unnamed parties.

These will be the unknown partners who will get the advantage of the tax-leasing arrangements. The contract is made between the dummy corporation and the parent corporation, and you get this flow down in which you see the $220 million in ships and the questionable tax shelters for the owners—who will be these partners-owners over here—whose names we do not even know, and are not even parties to the contract. And when the IRS goes to challenge these questionable tax shelters, we find certain results that I would like to discuss with you now as well.

What recourse does the Navy have if the ships are not delivered on time, because they made contracts with dummy corporations?

Now, the Navy will say there are certain warranties that flow from the parent corporation to the Navy to guarantee the contracts of the dummy corporation. But we now find ourselves in a legal jungle as to exactly who is doing what and the question that the Navy cannot answer for us is why are they making these contracts with dummy corporations other than to say: "This is the usual way business is done."

I don't accept that.

And, as if the taxpayer was not getting a bad enough deal, the Navy has gone one step further. Because no one can be certain whether the IRS will permit the entire $210 million per ship write-off, the Navy decided to indemnify the shipowners. Let me tell you what that is in plain English: The Navy tells the shipowners that the $210 million per ship tax break is highly questionable.

But the Navy says: "Don't worry—we will guarantee the tax break; either you get it, or we will pay it."

"And if you have to go to court, we, the Navy, will pay the cost of your high-priced attorneys. And if you lose," the Navy says, "no trouble, either." Not only does the Navy say it will pay every penny of the lost tax breaks, but it will also pay every penny of the interest—and every penny of the penalties.

Let me just point out the exact language, because I came from the business world before I came to the U.S. Senate. I have never seen language of this kind.

"If the Navy shall request the contractor to contest such disallowance * * * the charterer shall agree to pay the shipowner or such partner on demand all costs and expenses including reasonable attorneys' fees and expenses incurred by the shipowner or such partner in connection with contesting such disallowance;" and up here, "in case of any tax loss by a partner, the charterer"—the charterer is the Navy—"shall pay to the contractor an amount which shall be equal to the sum of the additional Federal income tax payable, plus any interest penalties or additions to the tax."

Where does the Navy say it is going to get this money? It says that it again will raid its operations and maintenance fund.

Mr. Chairman, I must say that never before have I seen one arm of the Government so willing to fight it out with another arm of Government in court.

The executive departments were never intended to compete against each other. When disputes arise between departments, the

proper place to resolve them is in the White House. That is the way it has always worked in the past.

But what we have here is a totally different approach. And I believe that it is one that goes contrary to our way of Government. What will we see next? Will the Navy sue the Air Force over which branch of the armed services has the right to use a certain landing field? Will the Department of Health and Human Services sue the Agriculture Department over food stamp eligibility? Will the Treasury Department sue the Labor Department over a dispute involving a pension plan? Most certainly not. But here we have the Navy suing the IRS indirectly and agreeing to pay attorneys' fees, taxes, penalty, interest.

That is exactly what the Navy is saying to the Internal Revenue Service: If you find that the owners of the ships that we are using do not qualify for certain tax breaks we will take you to court. And if we lose, we will pay the bill, not the taxpayer with whom you have the dispute.

And what if Congress changes the tax laws?

Mr. Chairman, if Congress changes the tax laws, the Navy has decided that those changes will not adversely affect the shipowners—the Navy will pay for any increases in their tax liability.

Mr. Chairman, it is Congress which is vested with the authority to make the law of the land, including our tax laws. It is the responsibility of the executive branch, including the Department of the Navy, to execute that law. For the Department of the Navy to tell a taxpayer that it will, in essence, be immune from any changes in the law is utterly outrageous.

The fact is that this provision may already be benefiting the shipowners, because last fall Congress enacted a change in the amount of tax writeoffs all taxpayers may take—known as a basis adjustment. The basis adjustment, you will recollect, in the past has been such that if you build a ship and lease it out, or even use it for yourself, you would wind up deducting 110 percent of your total cost, including the investment tax credit and accelerated depreciation.

Now, we have cut that back to 105 percent. The Navy says it will guarantee that the shipbuilders get the full 110 percent.

Because of these concerns, I wrote last Thursday to Defense Secretary Caspar Weinberger and Secretary of the Navy John Lehman to urge them to refrain from signing any further contracts of this type and to cancel those already signed. In addition, similar letters have been sent to OMB Director David Stockman and Treasury Secretary Donald Regan. I have also asked Finance Committee Chairman Robert Dole to have his committee start an immediate investigation into this raid on the Treasury.

With your permission, I would like at this time to be permitted to include in the record copies of those letters.

Chairman RANGEL. Without objection.

Senator METZENBAUM. Mr. Chairman, I urge you and your committee to do everything in your power to undo these sweetheart deals and to prevent the Department of Defense or any other Government agency from pursuing similar agreements. And I believe that it is important to get the commitment of the Air Force that its

recently announced leasing activity will not contain these sweetheart provisions.

Again, thank you for the opportunity to testify.

[The prepared statement and various charts and letters follow:]

STATEMENT OF HON. HOWARD M. METZENBAUM, A SENATOR FROM THE STATE OF OHIO

Mr. Chairman, I very much appreciate your giving me the opportunity to testify at this hearing.

The issue before us today, Mr. Chairman, has nothing to do with whether or not the Navy has a legitimate requirement for cargo ships. Instead, our focus is upon a method used by the Navy to acquire these ships that circumvents the budget and appropriations process, imposes substantial extra costs upon the taxpayer and jeopardizes the future readiness of our naval forces by converting the operations and maintenance budget into a procurement account.

The Navy, Mr. Chairman, has determined that thirteen cargo ships are required to support the Rapid Deployment Force. The ships could be purchased at a cost of $184 million a piece.

Instead of buying the ships, however, the Navy chose to take another route—to contract for the construction of the vessels and then rent them for a five year period with an option to extend the lease for up to 25 years.

What does this mean?

In dollars, it will mean a cost to the taxpayer of $415 million per ship over the term of the lease. That figure is for the ship only—it does not include the costs of personnel, maintenance and operations.

The Navy, under this arrangement, bears the financial risk in the event that any of the vessels are destroyed in wartime.

The Navy bears sole responsibility for future increases in fuel costs, wages, insurance and other operational expenses.

And if the navy decides not to renew any of its five year options for a ship, the taxpayers of this country are obligated to pay to the owners an amount equal to the fair market value of the vessel in question.

And this, Mr. Chairman, is only the tip of the iceberg.

I have cited a direct cost figure of $415 million per ship over the term of the lease.

But there are other costs—indirect costs—that very substantially increase the price that we the public will be required to pay. That is so because with this leasing arrangement, the United States Navy has gone into the business of selling tax shelters.

Since they are constructing these ships for lease, not sale, the shipowners intend to take an investment tax credit and depreciation deductions for the first five years. They plan also to deduct any interest they pay on bonds used to finance the construction. And according to a Navy study these tax writeoffs could cost the Treasury $210 million per each ship over the 25 year lease term.

That's fine with the Navy. The money doesn't come from their budget. But the money does come from the Federal Treasury in the form of taxes never paid. And in the end, it's money that will have to be made up by taxpayers who do not enjoy the benefit of these enormous write-offs.

I have already stated that it will cost more to lease than to buy these ships. But these deals are also bad in terms of their implication on the budget and appropriations process.

Congress has the responsibility for deciding how much money the Navy has to purchase weapons, and how much it has in order to maintain them in good working order. But the Navy has scuttled the congressional budget and appropriations process.

The $415 million per ship will not come out of the Navy's procurement budget as would ordinarily be the case in the purchase of a weapon or ship. Instead it will come out of the Navy's operations and maintenance account—the very money which the Navy has asked Congress for in order to keep its planes flying, its ships sailing, and its weapons firing.

In effect the Navy is robbing its operations and maintenance accounts to increase the size of its fleet.

If Congress doesn't address this issue now, we will soon lose control over military spending and permit the Department of Defense to decide its own procurement budget. One morning we will wake up and find in the morning papers that the MX missiles has just been leased out of operations and maintenance funds; that an aircraft carrier that Congress has excluded from the procurement budget is now sail-

ing with the U.S. Navy as a rented vessel; or that the President has landed at Andrews Air Force base in a rented Air Force One.

And who is the Navy contracting with?

The Department of Navy is signing contracts with dummy corporations which have as little as $100 in capital. In fact these companies were incorporated in Delaware just a short time before the contracts were signed. Frankly, Mr. Chairman, I am not certain why these contracts were signed with dummy corporations, but I believe that there are serious implications to such a practice. For example, what recourse does the Navy have if the ships are not delivered on time, if they have defects, or if they are destroyed before delivery?

And as if the taxpayer was not getting a bad enough deal, the Navy has gone one step further. Because no one can be certain whether the IRS will permit the entire $210 million per-ship-writeoff, the Navy decided to "indemnify" the shipowners. Let me tell you what that is in plain English:

The Navy tells the shipowners that the $210 million per ship tax break is highly questionable.

But the Navy says—don't worry—we'll guarantee the tax break, either you get it, or we'll pay it.

And if you have to go to court, we, the Navy, will pay the cost of your high-priced attorneys. And if you lose, the Navy says "no trouble either." Not only does the Navy say it will pay every penny of the lost tax breaks—but it will also pay every penny of the interest—and every penny of the penalties!

And where does the Navy say it will get this money? It says that it again will raid its operations and maintenance fund.

Mr. Chairman, I must say that never before have I seen one arm of the government so willing to fight it out with another arm in court. The Executive Departments were never intended to compete against the other. When disputes arise between departments, the proper place to resolve them is in the White House. That is the way it has always worked in the past.

But what we have here is a totally different approach. And I believe that it is one that goes contrary to our way of government. What will we see next? Will the Navy sue the Airforce over which branch of the armed services has the right to use a certain landing field? Will the Department of Health and Human Services sue the Agriculture Department over food stamp eligibility? Will the Treasury Department sue the Labor Department over a dispute involving a pension plan? Most certainly not!

But that is exactly what the Navy is saying to the Internal Revenue Service. "If you find that the owners of the ships that we are using do not qualify for certain tax breaks we will take you to court. And if we lose we will pay the bill, not the taxpayer who you have the dispute with."

And what if Congress changes the tax laws?

Mr. Chairman, if Congress changes the tax laws the Navy has decided that those changes will not adversely effect the shipowners—the Navy will pay for any increases in their tax liability.

Mr. Chairman, it is Congress which is vested with the authority to make the law of the land, including our tax laws. It is the responsibility of the Executive branch, incuding the Department of the Navy, to execute that law. For the Department of the Navy to tell a taxpayer that it will, in essence, be immune from any changes in the law is utterly outrageous.

The fact is that this provision may already be benefiting the shipowners, because last fall Congress enacted a change in the amount of tax write-offs all taxpayers may take—known as a basis adjustment. That provision would normally deny certain tax breaks to the shipowners. The Navy has indicated that because the price of the ships was negotiated prior to the enactment of that provision, the Navy will likely have to pay the extra amount.

Because of these concerns, I wrote last Thursday to Defense Secretary Caspar Weinberger and Secretary of the Navy John Lehman to urge them to refrain from signing any further contracts of this type and to cancel those already signed. In addition, similar letters have been sent to OMB Director David Stockman and Treasury Secretary Donald Regan. I have also asked Finance Committee Chairman Robert Dole to have his committee start an immediate investigation into this raid on the treasury.

Mr. Chairman, I urge you and your committee to do everything in your power to undo these "sweetheart" deals and to prevent the Department of Defense or any other government agency from pursuing similar agreements. And I believe that it is important to get the commitment of the Airforce that its recently announced leasing activity will not contain these "sweetheart" provisions.

Again, thank you for the opportunity to testify.

METZENBAUM REVEALS NAVY SHIP CONTRACTS WOULD SUBSIDIZE BILLIONS FOR FIRMS TO AVOID TAXES; CALLS FOR CANCELLATION OF CONTRACTS AND INVESTIGATIONS

Senator Howard M. Metzenbaum (D-Ohio) revealed today that contracts for the leasing of ships to be built for the U.S. Navy contain clauses that could put the Navy in the role of subsidizing tax avoidance by shipbuilders. Metzenbaum said the pacts could result in the payment of as much as $2.7 billion by the Navy if the planned tax breaks are disallowed. In addition, the Navy could be liable for hundreds of thousands of dollars in legal fees incurred by the builders in contesting decisions by the Internal Revenue Service.

"I have seen a lot of 'sweetheart' deals in my life, but none to surpass this one," said Metzenbaum. "The whole idea of the Navy leasing ships instead of buying them has raised some eyebrows on the Hill—but discovering that we would subsidize these companies if the IRS rules against these questionable tax breaks is absolutely unbelievable.

"Today I have written to Secretary of Defense Caspar Weinberger and Secretary of the Navy John Lehman to urge them to refrain from signing any further contracts of this type and to cancel those already signed. In addition, similar letters have been sent to OMB Director David Stockman and Treasury Secretary Donald Regan. I have also asked Finance Committee Chairman Robert Dole to have his committee start an immediate investigation in this raid on the Treasury.

"There are no two ways about it. The Navy Department is, in effect, committing a possible $2.7 billion in expenditures by guaranteeing questionable tax breaks to these shipbuilders.

"Basically they are saying to these firms: 'It's very possible that the IRS will rule against these tax breaks. But don't worry. First, we'll reimburse you for all those high-priced tax attorneys you'll have to hire. And even if you lose, we'll still take care of you by reimbursing you to the penny for all the tax breaks you would have received PLUS we'll give you the money for any penalties and interest!'

"We have also learned that the Navy is actually dealing with 'dummy' corporations that have been set up with as little as $100 in capital to handle contracts in the hundreds of millions of dollars.

"When my staff met with Navy Department officials, they were met with vague answers concerning these 'dummy' corporations. To compound it further, a Navy official later contacted my staff with a request to have us sign a paper that would classify these contracts as 'confidential' and therefore hide their terms from the public.

"At a time when we are looking for every possible way to increase revenue and decrease deficits, I find it unbelievable that a branch of our government would attempt to put over such an outrageous scheme to help firms avoid taxes," concluded Metzenbaum.

[Fact sheets, sample contract clauses and letters attached:]

FACT SHEET ON NAVY LEASING CONTRACTS

THE LEASES

The Navy has, or soon will, sign 13 separate contracts, with a total cost to the government of $1.688 billion, to lease 13 TAKX ships. The ships are to be used as "floating warehouses" storing arms, ammuniton, etc. for the Rapid Deployment Force.

The companies involved are: Maersk Lines Ltd: Five contracts costing $723 million; Waterman Steamship Corp.: Three contracts costing $343 million; General Dynamics: Five contracts costing $622 million.

The eight contracts with Maersk and Waterman have alredy been signed. The five General Dynamics contracts are pending. The 13 are identical in all significant respects.

HOW THE LEASES ARE STRUCTURED

The leases involve four parties:

The Contractor: In all 13 cases, the contractor is actually a "dummy" corporation set up solely for the purpose of signing the contract. Each "dummy" is chartered in Delaware and is capitalized with as little as $100. They are wholly-owned subsidiaries of the parent corporations (see below). Thus, the Navy has signed contracts to

build $184 million ships with corporations that have total equity value of as little as $100.

The partner/owner: The partners will be the equity owners of the vessels and will be the recipients of the tax benefits. As yet, though, there are no partners and thus we do not know who the eventual beneficiaries of the tax breaks will be.

The parent corporation: The parent corporation set up the "dummy" for reasons that are as yet unclear. The parent will separately contract with the "dummy" to actually provide the services called for in the lease agreement, such as manning the ship, operating it and maintaining it.

The charterer: The Navy is the charterer or the party leasing the ship.

TAX BENEFITS

The Navy has said these are service contracts. As such, the partners/owners would be entitled to wide ranging tax breaks. But there is a serious question as to whether they are, in fact, service contracts. They may be "conditional sales" contracts or leases since the Navy retains the right to purchase the ships either prior to delivery or anytime after the fifth year.

The average cost of each ship is $184 million. According to a Navy study, the Treasury would lose $210 million in taxes per ship over the 25 year life of each contract. The tax loss over the first five years would be $128.85 million per ship.

THE TAX INDEMNITY PROVISIONS

It is possible that the IRS may challenge some or all of the credits or deductions claimed. In that event, the lease stipulates that should this occur, the Navy may:

(1) Require the partner/owers to contest the IRS in court in which case the Navy is committed to paying reasonable legal expenses to defend the tax breaks and/or;

(2) If the deductions and credits are disallowed, in whole or in part, the Navy is obligated to compensate the partner/owners on a dollar for dollar basis for all tax benefits lost. And further, the Navy would pay any penalties and interest that might accrue.

Parent corporation	Date of incorporation	Capitalization
Maersk Line Ltd:		
Dummy Corporation:		
Extender Transport	Sept. 29, 1982	[1] 100
Expediter Transport	do	[1] 100
Expresser Transport	do	[1] 100
Expander Transport	do	[1] 100
Exporter Transport	do	[1] 100
Waterman Steamship Corp.:		
Dummy Corporation:		
WTAK–1, Inc	Dec. 15, 1982	[2] 1,000
WTAK–2, Inc	do	[2] 1,000
WTAK–3, Inc	do	[2] 1,000

[1] Common at $1 par.
[2] Common, no par.

Interests pursuant to this Charter and the Agreement to Charter. The Charterer shall not be entitled to further subcharter this Vessel without the prior written agreement of the Contractor, whose approval shall not unreasonably be withheld.

ARTICLE 40. TAX INDEMNITY

(a) If, solely as a result of any of the following events:

(1) this Charter being treated for Federal income tax purposes as a lease of the Vessel; or

(2) the Charterer or any officer, employee or agent thereof taking any action which is not required by the terms of this Charter or any document referred to herein or required by applicable law or regulations or failing to take any action which is expressly so required,

any Partner suffers, in any taxable year ending on or after the Commencement Date, a loss with respect to, or recapture of, any of the Tax Benefits (defined below) that would otherwise have been available for such taxable year, or if any Partner is required by the Internal Revenue Service to include in gross income for Federal income tax purposes during the Charter Period any amount as additional rental as a result of any nonseverable improvement or addition to the Vessel made by the Contractor at the request of the Charterer (any such loss, recapture or inclusion being hereafter referred to as a "Loss"), then the Charterer shall reimburse the Contractor as provided in paragraph (c) of this Article 40.

(b) "Tax Benefits" means the following with respect to the Vessel:

(1) current cost recovery deductions for Federal income tax purposes with respect to the Vessel over a recovery period of 5 years commencing with the taxable year of such Partner in which the Commencement Date occurs computed according to Section 168(b)(1) of the Code using a basis of the Vessel equal to Basic Capitalized Costs less Amortizable Fees and Expenses;

(2) current deductions for Federal income tax purposes determined in accordance with the Owner's method of accounting for interest on the Bonds after the Commencement Date; and

(3) Investment tax credits for Federal income tax purposes equal to 10% of the excess of Basic Capitalized Costs over Amortizable Fees and Expenses.

(c) In case of any Loss by a Partner, the Charterer shall pay to the Contractor an amount which, after reduction by the amount of all taxes required to be paid by such Partner in respect of the receipt or accrual of such amount, under the laws of the United States or any state or local government or taxing authority in the United States, shall be equal to the sum of (i) the aggregate amount of additional Federal income tax payable by such Partner as a result of such Loss, and (ii) the aggregate amount of any interest, penalties or additions to tax (other than interest, penalties or additions to tax arising from the failure of such Partner to file tax returns that are timely and proper as to matters unrelated to the transactions contemplated by this Charter or the acts or omissions of such Partner which are not reasonably the consequence of such event) payable by such Partner from time to time as a result of such Loss, provided, however, that the Charterer shall be required to pay the amount specified in this paragraph (c) only to the extent that the Contractor is required to and does pay such amount to such Partner pursuant to applicable provisions of the Bareboat Charter approved by the Charterer.

(d) The Contractor shall pay or cause each Partner to pay to the Charterer an amount equal to the sum of (i) the reduction in Federal income tax, if any, realized by such Partner attributable to a tax benefit arising from any Loss or from any circumstances resulting in a Loss, (ii) any tax reduction attributable to any tax deduction for tax, interest, penalties or additions to tax payable to any state or local government or taxing authority in respect of a payment by the Charterer under paragraph (c) above, and (iii) the amount of any additional Federal, state and local income tax benefits realized by such Partner as a result of any payment pursuant to this sentence; provided, however, that any disallowance of such reduction or the additional tax benefits subsequent to the year of realization by such Partner shall be treated as a Loss and subject to the provisions of paragraph (a).

(e) Any amount payable to the Contractor pursuant to paragraph (c) shall be paid not later than 20 days after receipt of a written demand therefor from the Contractor (but not prior to the earlier of (1) payment by such Partner of the additional Federal income tax that shall become due as a result of the Loss, and (2) the date such Partner shall suffer a

reduction in the amount of any refund of Federal income tax that such Partner would have been entitled to receive but for such Loss), accompanied by a written statement describing in reasonable detail the Loss and setting forth the computation of the amount so payable.

Any amount payable to the Charterer pursuant to paragraph (d) shall be paid within 20 days after the date on which such Partner shall realize any such reduction in Federal income tax and shall be accompanied by a written statement describing in reasonable detail the computation of the amount so payable.

(f) All computations required to be made under this Article 40 shall be made or caused to be made in the first instance by the Contractor and, if requested in writing by the Charterer within 30 days of the delivery of such computation to the Charterer, shall be verified by an independent public accounting firm of recognized national standing mutually acceptable to the Charterer and the Contractor.

(g) Upon receipt by the Shipowner or any Partner of a written notification from the Federal taxing authorities of a proposed Loss for which an amount may be payable by the Charterer in accordance with this Article 40 (a "Disallowance"), the Contractor shall promptly notify the Charterer of such Disallowance (which notice to the Charterer shall include all relevant information relating to such Disallowance which may be particularly within the knowledge of the Contractor, the Shipowner and the Partners) and shall cause such Partner not to pay any tax relating to such Loss for a period of 45 days following such notice to the Charterer or, if shorter, two days less than the period specified (including available extensions) for payment in such notification.

If (A) the Charterer in writing shall request the Contractor to cause the Shipowner or such Partner to contest such Disallowance within the period specified in the preceding paragraph and (B) the Charterer shall agree to pay the Shipowner or such Partner on demand all costs and expenses, including, without limitation, reasonable attorneys' fees and expenses, incurred by the Shipowner or such Partner in connection with contesting such Disallowance to the extent set forth below, then the Contractor shall, except as set forth below, cause the Shipowner or such Partner to take such action in contesting such Disallowance as may be reasonably requested by the Charterer (including the appeal of any adverse determinations).

The Shipowner or such Partner, at its sole option, may choose to pursue or to forego any and all administrative

appeals, proceedings, hearings and conferences with the relevant taxing authorities with respect to such Disallowance (unless and to the extent pursuit of any such proceedings shall be required to secure judicial remedies), but will contest such Disallowance in a court of competent jurisdiction selected by the Shipowner or such Partner in its sole discretion.

The Contractor shall cause the Shipowner or such Partner to permit the Charterer to participate in any administrative and/or judicial proceeding.

The Contractor shall not permit the Shipowner or such Partner to enter into a settlement or other compromise with respect to any Loss without the prior written consent of the Charterer, unless the Contractor waives its right to be indemnified with respect to such Loss under this Article 40 and pays to the Charterer any amounts theretofore paid by the Charterer (which have not theretofore been repaid to the Charterer) with respect to such Loss together with the amount of any interest any Partner would have received had such Partner received a refund of such taxes on the date the Contractor makes such payment to the Charterer, plus an amount equal to any tax benefit received by such Partner solely as a result of any payment pursuant to this sentence to the Charterer.

If, after actual receipt by the Contractor of an amount of any indemnity paid by the Charterer and attributable to a Loss, the extent of the Disallowance shall be established by the final judgment or decree of a court or administrative agency having jurisdiction thereof, the Contractor shall pay or cause each Partner to pay, within 30 days, to the Charterer any refund or reduction of a deficiency or offset received by such Partner with respect to such Disallowance, together with any interest (other than interest for the period after any taxes arising from such Loss or any circumstances resulting in such Loss were paid by such Partner until such taxes were paid or reimbursed by the Charterer) paid thereon by the taxing authority fairly attributable to such portion of such refund or any interest that would have been received if no other matters had been involved in such proceeding.

(h) For purposes of this Article 40, the term "Partner" shall mean and include the affiliated group of corporations of which any Partner is or shall become a member, if such group shall have filed a consolidated Federal income tax return, and the term "Charterer" shall mean the Department of the Navy.

(i) The obligations of the Charterer and the Contractor under this Article 40 shall survive the expiration or earlier termination of this Charter.

(j) The Termination Value schedule shall be adjusted to reflect any payment by the Charterer for any loss pursuant to this Article 40 and to take into account the circumstances giving rise to such Loss.

(k) The Charterer may require each Partner to agree in writing to the terms of this Article 40 prior to making any payment under this Article 40. If the Contractor does not fulfill its obligations under this Article 40 to cause the Shipowner or any Partner to take, or fail to take, any action, then the Contractor shall be deemed to have waived its right to be indemnified under this Article 40, and the Contractor shall pay to the Charterer the amount specified in the fifth paragraph of paragraph (g) of this Article 40.

ARTICLE 41. EXCEPTIONS

An Act of God, enemies, fire, restraint of princes, rulers of people, all dangers and accidents of the seas, rivers, machinery, boilers, steam and navigation, and errors of navigation throughout this Charter Party are always mutually excepted; provided, however, that nothing contained in this Article shall relieve the Charterer from liability for the payment of Capital Hire or Termination Value pursuant to Article 5 of this Charter or any amount payable under Articles 10(h), 11 or 16(c).

ARTICLE 42. GENERAL PROVISIONS

Those general provisions and standard Government clauses as published in the Defense Acquisition Regulation (formerly known as the Armed Services Procurement Regulation and found at 32 CFR, Part 7) which are listed in Annex B hereto, are incorporated herein by reference, and shall have the same force and effect as if set forth fully herein.

ARTICLE 43. SPECIAL PROVISIONS

The provisions of this Article shall prevail over any other provisions herein inconsistent therewith.

(a) The Charterer agrees to reimburse the Contractor for necessary communication expenses incurred in the operation of the Vessel except when such expenses are the Contractor's obligation under the provisions of this Charter or are incurred for the convenience of the Contractor, the Vessel, its Master, Officers or crew.

(b) In the event the Charterer provides a utility

U.S. SENATE,
COMMITTEE ON LABOR AND HUMAN RESOURCES,
Washington, D.C., February 23, 1983.

Hon. CASPAR W. WEINBERGER,
Secretary of Defense,
The Pentagon, Washington, D.C.

DEAR MR. SECRETARY: I recently learned that the thirteen contracts the Navy has signed to lease TAKX ships contain clauses that could obligate the United States government to subsidize tax avoidance by the owners of the vessels.

As you know, the leasing arrangement provides substantial tax benefits to the shipowners. There is, however, a serious question whether all of these tax benefits are legal. In fact, it is possible that the Internal Revenue Service may challenge some or all of the credits and deductions.

But the contracts cover this possibility with a tax indemnity provision. This provision obligates the Navy either to pay legal costs of the owners to fight an IRS challenge and/or compensate the owners on a dollar for dollar basis for any tax breaks disallowed, including penalties and interest.

I have also discovered that the actual contractors in each of the thirteen leases are "dummy" corporations, some of which were capitalized with as little as $100. Thus, the government is in the absurd posture of signing a contract to build a $184 million ship with companies that, in effect, have no equity.

Finally, Navy officials have told my staff that these payments, if made, would come out of their operation and maintenance accounts. As you know, the President and Congress have repeatedly stressed the need to build up troop readiness and assure adequate supplies and spare parts for our forces. In light of this, I would like you to justify this potential $2 billion raid on the O&M account.

This tax indemnity provision is outrageous. It amounts to government-subsidized tax avoidance. I urge you to refrain from signing any of the five remaining TAKX contracts until Congress has thoroughly reviewed the appropriateness of this tax indemnity clause. Further, I urge you to cancel those contracts already signed or at the very least reopen the contracts and delete this offensive provision.

Thank you for your prompt attention to this matter.

Very sincerely yours,

HOWARD M. METZENBAUM, *U.S. Senator.*

U.S. SENATE,
COMMITTEE ON LABOR AND HUMAN RESOURCES,
Washington, D.C., February 23, 1983.

Hon. JOHN LEHMAN,
Secretary of the Navy,
The Pentagon, Washington, D.C.

DEAR MR. SECRETARY: I recently learned that the thirteen contracts the Navy has signed to lease TAKX ships contain clauses that could obligate the United States government to subsidize tax avoidance by the owners of the vessels.

As you know, the leasing arrangement provides substantial tax benefits to the shipowners. There is, however, a serious question whether all of these tax benefits are legal. In fact, it is possible that the Internal Revenue Service may challenge some or all of the credits and deductions.

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Finally, Navy officials have told my staff that these payments, if made, would come out of their operation and maintenance accounts. As you know, the President and Congress have repeatedly stressed the need to build up troop readiness and assure adequate supplies and spare parts for our forces. In light of this, I would like you to justify this potential $2 billion raid on the O & M account.

This tax indemnity provision is outrageous. It amounts to government-subsidized tax avoidance. I urge you to refrain from signing any of the five remaining TAKX contracts until Congress has thoroughly reviewed the appropriateness of this tax in-

demnity clause. Further, I urge you to cancel those contracts already signed or at the very least reopen the contracts and delete this offensive provision.

Thank you for your prompt attention to this matter.

Very sincerely yours,

HOWARD M. METZENBAUM, *U.S. Senator.*

U.S. SENATE,
COMMITTEE ON LABOR AND HUMAN RESOURCES,
Washington, D.C., February 23, 1983.

Mr. DAVID STOCKMAN,
Director, Office of Management and Budget,
Executive Office Building, Washington, D.C.

DEAR MR. DIRECTOR: The Navy recently signed contracts with private parties to lease thirteen TAKX ships for use by the Rapid Deployment Force. I recently learned that these contracts contain a highly objectionable clause that obligates the United States government to subsidize tax avoidance by the owners of the vessels.

As you know, the leasing arrangement contemplates substantial tax benefits to the partners. There is, however, a serious question whether all of these tax benefits are legal. In fact, it is quite possible that the Internal Revenue Service may challenge some or all of the credits and deductions.

But the contracts contain a tax indemnity clause which obligates the Navy to pay either reasonable legal expenses of the owners to fight an IRS challenge and/or to compensate the owners on a dollar for dollar basis for any tax breaks disallowed. Further, the Navy would also compensate the owners for any penalties and interests that might be assessed against them.

This tax indemnity provision is outrageous and merits your immediate attention. As you can readily see, it has obvious budgetary implications: it could trigger payments of more than $2 billion to the shipowners. Navy officials have told my staff these payments would come out of their operation and maintenance accounts. I would like to know whether you approve of this arrangement and, if so, how it can be justified in light of projected future federal budget deficits. Further, I would like to know whether it is the policy of this administration to pay the legal expenses of its contractors. In addition, the President and Congress have repeatedly stressed the need to build up troop readiness and assure adequate supplies and spare parts for our forces. In light of this, I would like to know how we can risk a $2 billion raid on our O & M account.

Finally, I understand the Pentagon is considering similar leasing deals in the future. I would like to know if this administration plans to make a practice of guaranteeing any questionable corporate tax breaks that might be involved in subsequent contracts.

Very sincerely yours,

HOWARD M. METZENBAUM, *U.S. Senator.*

U.S. SENATE,
COMMITTEE ON LABOR AND HUMAN RESOURCES,
Washington, D.C., February 23, 1983.

Hon. DONALD T. REGAN,
Secretary of the Treasury,
Washington, D.C.

DEAR MR. SECRETARY: The Navy recently signed contracts with private parties to lease 13 TAKX ships for use by the Rapid Deployment Force. I recently learned that these contracts contain a highly objectionable clause which could literally obligate the United States government to subsidize tax avoidance by the owners of the vessels.

As you know, the leasing arrangement contemplates substantial tax benefits to the partners. There is, however, a serious question whether all of these tax benefits are legal. In fact, it is quite possible that the Internal Revenue Service may challenge some or all of the credits and deductions.

But the contracts contain a tax indemnity clause which obligates the Navy to pay either legal expenses of the owners to fight an IRS challenge and/or to compensate the owners on a dollar for dollar basis for any tax breaks disallowed. Further, the Navy would also compensate the owners for any penalties and interest that might be assessed against them.

This tax indemnity provision is outrageous and merits your immediate attention. Eight contracts have already been signed. But it is not too late to cancel them or revise them. Nor is it too late to prevent this noxious clause from being included in the five remaining contracts. Specifically, given the questions surrounding the tax aspects of the leasing arrangement and given the possible budgetary impact of the indemnity provision, I believe you should raise in the Cabinet the question of whether it is appropriate and acceptable for one part of the government, in this case the Navy, to subsidize a legal case against the IRS.

I appreciate your prompt attention to this matter. I look forward to hearing from you shortly.

Very sincerely yours,

HOWARD M. METZENBAUM, *U.S. Senator.*

U.S. SENATE,
COMMITTEE ON LABOR AND HUMAN RESOURCES,
Washington, D.C., February 23, 1983.

Hon. ROBERT DOLE,
U.S. Senator,
Washington, D.C.

DEAR BOB: As you know, the Navy recently signed contracts with private parties to lease 13 ships for use by the Rapid Deployment Force. I recently learned that these contracts contain a highly objectionable clause that could literally obligate the United States government to subsidize tax avoidance by the owners of the vessels.

The leasing arrangement contemplates substantial tax benefits to the partners. There is, however, a serious question whether all of these tax benefits are legal. In fact, it is quite possible that the Internal Revenue Service may challenge some or all of the credits and deductions.

But the contracts contain a tax indemnity clause which obligates the Navy to either pay reasonable legal expenses of the owners to fight an IRS challenge and/or compensate the owners on a dollar for dollar basis for any tax breaks disallowed. Further, the Navy would compensate the owners for any penalties and interest that might be assessed against them.

I believe this entire arrangement compels the immediate attention of the Senate Finance Committee. Specifically, I urge you to open a full-fledged probe of why this tax indemnity provision is included in the contract and what are its implications in terms of lost tax review and future tax policy. I also encourage you to direct the Secretary of Defense to refrain from signing any similar contracts and to cancel all existing contracts pending a full and complete investigation by your committee.

Very sincerely yours,

HOWARD M. METZENBAUM, *U.S. Senator.*

Chairman RANGEL. Thank you, Senator.

As a lawyer and lawmaker, where does title lie with the ships that we are talking about?

Senator METZENBAUM. The dummy corporation would have title.

Chairman RANGEL. With regard to the contract that the Navy will have with the dummy corporation, what if these ships were ordered deployed in a dangerous area, and a dispute arose over the Navy's authority. Could the dummy corporation consider the deployment order a breach of contract?

Senator METZENBAUM. Consider the employment of the ship?

Chairman RANGEL. What I am trying to do is examine the issue of ownership. There may be some question as to whether the shipowner is the dummy corporation or the partnership.

Senator METZENBAUM. Mr. Chairman, I think title will be vested with the partner-owners.

Chairman RANGEL. One thing is abundantly clear, the shipowner is not the U.S. Navy.

Senator METZENBAUM. It is not the Navy, and when the contracts are being entered into, the Navy doesn't even know who the owners will eventually be.

Chairman RANGEL. If there is a dispute between the owners and the Navy as to deployment of the ships, would not that matter have to be resolved in the courts rather than in the Pentagon?

Senator METZENBAUM. Absolutely, and the only place you could resolve it is in the courts. If we needed the ships at that moment we would find ourselves in a position of being involved in a legal wrangle, rather than using the ships for the purposes for which they are needed.

The Navy may say that they have assurances that there will be people on the ship from the Department of Defense or from the Navy, but when somebody has a contractual relationship with you, and you need the ships, it is not quite the same as if the Navy owned the ships themselves.

Chairman RANGEL. And while you said that some of the examples that you made as related to the aircraft carriers and MX missiles may not be realistic, there is certainly nothing that would prevent jeeps, trucks, and aircraft that could be used for commercial purposes from being contracted for in this very same manner?

Senator METZENBAUM. Unless Congress puts a halt to this procedure, you may anticipate that; and not only the Navy but other arms of the Government will follow the same procedure as a means of determining their own budgetary requirements.

Chairman RANGEL. When you are determining our military needs by branch, do they share with members of the Senate Budget Committee the proposed procurement methods for certain items and the method by which they will be paid?

Senator METZENBAUM. Until the news media opened this issue up to the public, I, as a member of the Budget Committee, had never heard of it and I don't think any other member of the budget committee had ever heard of it.

Chairman RANGEL. Under this method of acquiring property to meet the needs of the Defense Department, the taxpayers and the Congress would really not know the true extent of budget obligations until the Defense Department informs us of the procurement method.

Senator METZENBAUM. I said, "no other member of the Budget Committee," but it is a fact that the Navy sent a letter notifying John Tower, who is a member, and I think Mark Hatfield, who is not a member of the Budget Committee, that they were proceeding along this line, so I don't want the record to be incorrect; and might I say that the Budget Committee as a budget committee was not informed of this process, and that is a critical issue.

Chairman RANGEL. Mr. Pickle.

Mr. PICKLE. I don't have any questions.

I want to compliment you for joining us here this morning and for taking such a keen interest in the subject.

I know that we are doing it without prejudice to the Navy, because the Navy needs these ships.

The method is what we are questioning. I would just make this observation: I don't feel that the Navy tried to slip this by. I think it was something that had been talked about, discussed in the various agencies, but this is one of the first times in 10 years that it has been attempted on a large basis like this; it needs thorough

public examination and that is the reason we are having these hearings.

Senator METZENBAUM. I agree.

Chairman RANGEL. Mr. Duncan.

Mr. DUNCAN. Senator, the dummy corporations, would you mind naming those that you are familiar with?

Senator METZENBAUM. Yes. I know one, the Maersk Co. has used five corporations: Extender Transport, Expediter Transport, Expresser Transport, Expander Transport, and Exporter Transport, all formed on September 29, 1982.

Mr. DUNCAN. All of those were formed in 1982.

Senator METZENBAUM. All on the same day, all formed with $100 capitalization. And the Waterman Steamship Corp. formed three corporations on December 15, 1982, called WTAK-1, 2 and 3; each of those formed for $1,000 capital.

Mr. DUNCAN. Is your interest recent? You are not inferring that this has been going on for 15, 20 years. Apparently you referred to leasing as a new thing that has just started in recent years?

Senator METZENBAUM. What I am saying is that I don't know whether the Navy has been leasing in the past, but certainly the question of leasing in connection with tax breaks and indemnification for the tax breaks is recent, Mr. Duncan.

Mr. DUNCAN. Why do you single out the Navy, and not the Treasury and the Postal Department and the other departments that have been leasing for years and providing tax breaks? Also the municipalities that are leasing? For example, in your own city the Federal Government has leased buildings, and in my city, our transit system benefits, and the chairman's subways in New York also benefit from leases.

You are just touching the tip of the iceberg if you talk about tax equity. I wondered why you singled out the military?

Senator METZENBAUM. Mr. Duncan, I have joined with Senator Dole on the whole question of the safe harbor leases provision, and I was certainly one of those whose voice was heard loud and clear about the matter of selling tax breaks under safe harbor leasing. I certainly don't attack the question of people, property, and business using leasing procedures.

My concern is that the Navy is joining in a relationship with a lessor to work out an arrangement to use the tax breaks to circumvent the appropriation and authorization process, and then going on to indemnify private individuals. I have never seen a situation where there is an indemnification if the tax breaks don't go through.

Mr. DUNCAN. You are not opposed to the Treasury renting a building, say, in my town or your town, where they have rented buildings, but there is tax benefits to the lessor?

Senator METZENBAUM. I have no problems with that.

Mr. DUNCAN. You are not opposed to tax benefits going to the lessor in such an instance?

Senator METZENBAUM. I would say that I might have some policy considerations and concerns about the specifics, but generally speaking, I am not opposed to the Navy or any arm of Government leasing a building or three floors.

Mr. DUNCAN. I can't see where you are consistent with your ideas.

Senator METZENBAUM. The distinction is that in this instance the Navy has worked out with the lessor somewhat of a scheme to reduce the price and to not let it show up in the authorizing and appropriations process, and then to see to it that the tax break is accorded. When the Navy leases three floors of a building, they don't guarantee that the landlord is going to get the tax breaks.

Mr. DUNCAN. If the Navy follows the same policy, you wouldn't oppose the Navy for renting buildings?

Senator METZENBAUM. No. You say if the Navy follows the same——

Mr. DUNCAN. Same policies as other agencies?

Senator METZENBAUM. No, I wouldn't be opposed to that.

Mr. DUNCAN. I understand, too, that you would support appropriations to purchase these ships outright if they were needed?

Senator METZENBAUM. I am sorry?

Mr. DUNCAN. You would support appropriations to purchase these ships outright?

Senator METZENBAUM. I think that would be a better policy for the Government, yes.

Mr. DUNCAN. Would you support that?

Senator METZENBAUM. Yes.

I am due on the floor at a quarter of 10. They are holding a measure for me.

Chairman RANGEL. The Senator did explain his time constraint. Perhaps Mr. Dorgan and Mr. Martin would be prepared to submit questions to you for the record.

Senator METZENBAUM. I asked them to hold it until quarter of 11.

My apologies to you, Mr. Martin, and to you, Mr. Dorgan.

Please forgive me.

Chairman RANGEL. Our next witness is the Honorable Don Pease, a member of the Ways and Means Committee.

STATEMENT OF HON. DON J. PEASE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. PEASE. I thank you very much. I appreciate the opportunity to appear before the Oversight Subcommittee as it examines the impact of Federal leasing programs.

As you know, I am interested as a member of the Ways and Means Committee not only in the specific aspects of these leasing practices, but also in the general public policy questions that arise.

I commend you, Mr. Chairman, for scheduling your review and also my colleague and friend, Mr. Pickle, for his hard work that brought the Navy leasing practices to the public's attention.

Mr. Chairman, I first became aware of DOD leasing practices because of a Navy contract that remains unresolved in my own Ohio district.

Last fall, the Navy awarded a contract to Ocean Carriers, Inc., of Houston, Tex., for construction of five T-5 tanker ships. Ocean Carriers obtained the contract from the Navy at least partially be-

cause of the urging of the Ohio congressional delegation at my request.

Since plans call for some of the work to be subcontracted to the American Shipbuilding Co., which has a shipyard in my congressional district.

Since last year's representations by the contractors to Ohio, neither the Navy, the winner of the contract, Ocean Carriers, nor the shipbuilding subcontractor, has been accountable to the Congress.

My requests of the subcommittee for information on construction sites and timetables have been completely ignored. Repeated phone calls have gone unanswered by the subcontractor.

The Navy has not even been able to supply me a copy of the contract and has told my office that their only concerns now are that the ships be delivered as contracted.

Otherwise, applicable rules over matters such as priority for labor surplus areas which northern Ohio is, water off the Navy's back.

Although they are easy to lose in the specifics of the complicated contracts, the broad public policy issues at stake are fairly simple.

Is it wise and efficient for what would normally be direct purchases by the Government to be shifted to subsidized leases?

I am extremely concerned that the Congress, despite what the Navy would refer to as a congressional approval process, has largely been left out of the build and charter procurement arrangement.

I am concerned that direct purchase costs have conveniently been shifted to the revenue side of the budget as non-Government owner-builders of build-and-charter assets take full advantage of investment tax credit and accelerated depreciation tax benefits.

Claims by the Navy that their lease practices result in net savings to taxpayers are clouded by variables that the Navy either ignores or misconstrues.

For example, in the T-5 tanker case that I am familiar with, the Joint Committee on Taxation at my request looked at the consultant study that the Navy relies on to show that build and charter is cheaper than direct purchase. While the T-5 tanker ships would have a direct cost of $64.5 million, the consultants conclude that the Government would spend $53.5 million to lease each ship.

However, the Joint Committee looked at that study and found that it, quote "Incorrectly double accounts income tax and interest income, assumes the ship to be worthless after the 20-year lease, and treats the lessor's legal and investment banker costs as cost of purchase."

If these factors are considered, the result is that each T-5 tanker would cost $9.6 million more under the Navy method than under direct purchase according to the Joint Committee on Taxation staff.

I also asked the joint committee to tell me if it would be possible that the income from the build-and-charter method might be treated as a foreign-source income, thus avoiding more U.S. Federal income taxes. The joint committee staff replied that, depending on several factors, "As a result the contractor would pay no U.S. taxes on its profits from the transaction and very likely would not pay any foreign tax either."

Finally, Mr. Chairman, I am concerned that use of lease-or-charter arrangements will allow Federal agencies to distort the true picture of their annual cost by spreading what would normally be a single year's direct budget outlays over the multiple years of the lease-or-charter contract.

I believe that it is very important that the tax-writing committees of the Congress assert responsibility over lease-and-charter practices given those schemes' heavy reliance on the tax code. Lease-and-charter practices have clearly stretched Congress' intent over leasing in particular, and the ITC and ACRS in general, to the breaking point.

Congress current minimal involvement must increase so that the effects of leasing practices in the budget are considered comprehensively.

Thank you very much, Mr. Chairman.

Chairman RANGEL. Thank you.

Mr. Pickle.

Mr. PICKLE. Mr. Chairman, I have no questions. I noticed Mr. Pease's interest in this subject, and I know he personally expressed his interest in this subject.

Thank you.

Chairman RANGEL. Mr. Martin.

Mr. MARTIN. Thank you, Mr. Chairman. I want to welcome a member of this committee to testify on this important subject. You mentioned that a constituent company within your district, American Shipbuilding, had blown the whistle on this practice, so to speak, and protested this particular practice.

Were they seeking to sell such ships to the Navy or were they one of the companies potentially trying to take part in the leasing and happened to lose in the bidding?

Mr. PEASE. Neither one, Mr. Martin.

Mr. MARTIN. They just became aware of it?

Mr. PEASE. This company did not exactly blow the whistle on this situation.

Actually, American Shipbulding Co., which has yards in Lorain, Ohio, Nashville, Tenn., and Tampa, Fla., came to me last June and asked for my help in getting the T-5 tanker contract for Ocean Carriers, Inc., of Texas. Ocean Carriers would be the lessor and American Shipbuilding Co. would build the ships for Ocean Carriers.

The plan that American Shipbuilding Co. had in mind was to build the midsections in Nashville, the bows and sterns in Lorain, and to float them all——

Mr. MARTIN. And end up somewhere around Houston?

Mr. PEASE. Do final assembly in Tampa somewhere. And I agreed to help as did the entire Ohio delegation to urge the Navy to grant this award to Ocean Carriers, Inc.

When the award was granted then we began to get vibrations that American Shipbuilding Co. was changing its mind and might not do the work in Lorain, Ohio, after all.

As you might imagine, that piqued my interest in the arrangement by which it was done. Of course what I found was that because this is a lease arrangement through a third party, and not a direct purchase, the normal provisions of U.S. law relating to labor

surplus areas and giving preference to those areas do not apply. And also that American Shipbuilding Co., because its contract with Ocean Carriers, and not with the Navy, is free to do what it jolly well pleases about locating the ship construction.

Mr. MARTIN. This is fascinating. They got the contract but they doublecrossed the wrong guy it sounds like?

Mr. PEASE. Well, I refer to it not in such quite harsh terms as doublecross. My term is a breech of faith with me. They have said they would do the work and they have decided not to.

Mr. MARTIN. They breached the wrong faith.

Mr. PEASE. That is true.

Mr. MARTIN. You are concerned about not only the total cost as we are, that it all be taken into account and that it be represented as part of the Defense budget, if we can show the amount of tax loss to the Treasury. Are you not also concerned about congressional oversight responsibilities?

There are committees of the House and Senate, the Armed Services Committees and Appropriations Committees, that should have been tied into this process and in fact it appears that both, all such committees were aware of it. It has been discussed for some years. In fact, no contracts were to be issued until the committee signed off.

Mr. PEASE. Right.

Mr. MARTIN. Both Senator Tower and Chairman Addabbo have letters in a hearing of another committee where they indicated where Chairman Addabbo, on the basis of the report prepared for the Appropriations Committee, said it is clear the Navy's proposal is the right way to go.

Are you saying that they were negligent in their oversight responsibilities?

Mr. PEASE. No, I am not. I would say the oversight is insufficient and incomplete, however.

There are four committees, House Armed Services and Senate Armed Services and both Appropriations Committees that technically have to sign off on these lease arrangements.

In the letter that Mel Price——

Mr. MARTIN. I think you are implying they should not have signed off if they had taken a good look at the practice. If they were not willing to appropriate the money, they should have been more careful about signing off on a tax break.

Mr. PEASE. Personally, I agree with that.

In the letter Mel Price sent in which he signed off, he did raise concerns about the process. It is interesting to note that the Senate Appropriations Committee never did sign off. Senator Stevens, chairman of the relevant subcommittee, he never did sign off and in December, the Navy sought a legal opinion from its own General Counsel about whether it was really necessary for the Senate Appropriations Committee to sign off.

As you might expect, the Navy Counsel wrote back that it was not necessary technically so the contract was executed without even the completion of the middle oversight that we have built into the current system.

Mr. MARTIN. It is your opinion now that even if American Shipbuilding and Ocean Carriers had stuck with their original plan of

building part of the ship in Lorain, Ohio, it still would have been a mistake in policy?

Mr. PEASE. I think in terms of overall Government policy, that leasing rather than buying, direct purchase, has distinct disadvantages for the taxpayers and for the Navy itself.

Mr. MARTIN. And have you considered the extent to which there is also abundant precedent for that, as Mr. Duncan pointed out, in the fact that local governments and, I suppose, nonprofit operations and the GSA in leasing furniture and buildings, also take advantage of such leasing arrangements which provide tax breaks to the lessors and which thereby similarly hide the total cost of equipment and work space in the Treasury as opposed to their own budgets.

Have you thought much about that?

Mr. PEASE. In the first place, I would say a distinction has to be made. I am sure Mr. Duncan would see that distinction. I was a businessman before I came to Congress, and there are lots of things which, over the past 20 or 30 years, have been customarily leased—furniture, buildings, automobiles, and so on.

I think what we have seen now in the last few years is a vast expansion of that concept and I think it is a legitimate question whether it is appropriate to expand the concept.

Certainly it is appropriate to question the concept in terms of the Navy because of the questions that Senator Metzenbaum raised before about litigation on the availability of a ship during war.

I think when we are talking about the Navy substituting millions of dollars of direct purchase—which would have to be considered during our budget considerations—for leasing arrangements which is not then very much, we need to look into it.

Mr. MARTIN. Thank you, Mr. Chairman.

Chairman RANGEL. To your knowledge, with the exception of New York City, State and local budgets are not before any of the Senate or House committees or subcommittees; is that correct?

Mr. PEASE. To my knowledge, no, sir.

Chairman RANGEL. As relates to the Armed Forces Committee and Appropriations Committees of the House and Senate, it is not within their jurisdiction to determine what tax implications may be in the method of purchase?

Mr. PEASE. That is correct.

Chairman RANGEL. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

In line with the question that Mr. Duncan asked of Senator Metzenbaum, I wanted to ask Mr. Pease whether it isn't true that the tax bill passed by Congress in 1981 has so changed the method of depreciation and other opportunities for tax writeoffs that the contractor-lessors are able to write off this ship under ACRS in 5 years, a ship that will last at least 30 years.

Hasn't that now made more attractive certain leasing arrangements similar to the one we are talking about today?

Mr. PEASE. In my opinion, it definitely has.

Mr. DORGAN. Wouldn't that suggest then we may see a lot more of these kinds of arrangements because the changes in the 1981 law—ACRS, for example—largely abandons reality in determining what the reasonable writeoff would be?

Mr. PEASE. Yes, I think that is a reasonable assumption.

I suspect that there are investment counselors and investment bankers and lawyers who can make a lot of money by looking for these arrangements and extending them to new areas.

Mr. DORGAN. I raise the issue because there has been a period of time in which the Navy has not proposed leasing on this scale. I suspect that the 1981 act changing ACRS and the ITC has made these kinds of arrangements substantially more attractive.

I think most of us agree that if these ships are needed they ought to be built. But if they are needed and they are built you certainly shouldn't choose the avenue that costs the taxpayers the most amount of money to build them. That appears to be what happened in this case.

I just wanted to make that point. I appreciate your testimony, Mr. Pease.

Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman. I have no particular questions but would like to say that I have always admired your frankness, Mr. Pease. I want you to know that I appreciate your telling us exactly what motivated your—Senator Metzenbaum did not tell us that—but what motivated your interest in this problem.

I commend you for it.

Mr. PEASE. Thank you, Mr. Chairman.

Mr. DUNCAN. Thank you.

Mr. PICKLE [presiding]. Thank you, Mr. Duncan.

Now the Chair recognizes our colleague, Congressman Dyson, to present his testimony. We are glad to have you here this morning, Mr. Dyson.

STATEMENT OF HON. ROY DYSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MARYLAND

Mr. DYSON. Thank you, Mr. Chairman.

I would like to thank you and the distinguished members of the committee for the opportunity to share with you some of my observations in connection with the Navy's build-and-charter program.

As you know the program involves the construction and conversion of ships which upon delivery will fulfill an urgent requirement in our Nation's Navy. I realize some serious questions have been raised recently regarding the advantages of financing such assets through the method known as leverage leasing.

I hope we can all resolve these questions in the immediate future and continue the existing contracts in their entirety.

I would like to share with each of you this morning some of the nonfinancial advantages which in my opinion must weigh heavily in the balance of any decisions connected with this important program.

As a member of the House Armed Services Subcommittee on Seapower, the Merchant Marine Subcommittee on Merchant Marine, I have the advantage of viewing both the commercial and naval shipbuilding requirements. As a maritime nation we are in desperate shape. Less than 4 percent of the goods we export are carried on U.S.-flag ships manned by U.S. crews.

The reason for this situation principally is the lack of a competitive posture with other maritime nations and a world recession which pulled down the demand for international commerce.

Reversing these trends will not be accomplished overnight we realize, but efforts must be taken now to prevent the continued erosion of our Nation's shipbuilding and industrial base.

In 1982 there were only eight new commercial ship construction orders placed on the books. It is not anticipated this bleak condition will improve much in 1983.

At this time no new orders have been placed for new construction. Things will probably get much worse in the shipbuilding industry before they ever improve.

But improve they must if we hope to be engaged in the international trades by the end of this century. Without long-range comprehensive plans to revitalize shipbuilding in America our Nation's merchant marine may be on the verge of extinction.

Reversing this trend will not be without some hindrance but in the meantime we must do all we can to preserve the vital elements of our shipbuilding industrial base.

The build-and-charter program which contemplates construction and conversion of 13 TAKX ships is a positive step in this direction.

The Naval shipbuilding program authorized over the last two years will not in itself maintain the shipbuilding industrial base that would be essential in a future conflict.

Nearly three-fourths of the naval shipbuilding will go to only 4 shipyards that build aircraft carriers, nuclear submarines and the Aegis guide and missile cruisers. Yet the present base is composed of 26 shipyards and have the facilities and work force to construct ships. Less than half these yards are currently constructing naval vessels. There is little prospect that any additional yards will be employed in the naval shipbuilding program.

All of this points to the importance of the Navy's build-and-charter program which allows prompt acquisition of much needed assets which would otherwise be impossible under existing budget constaints.

Maintenance of a strong maritime capability is not solely a military interest and the importance goes beyond the defense needs of our country.

Maritime sectors of the economy contribute to the general welfare of the American people. Ocean-borne commerce brings one-third of our daily use of petroleum products from different parts of the globe. It also brings many strategic and critical materials essential to both the civilian economy and to the maintenance of our national defense.

Most significantly the build-and-charter program will engage four important shipyards in naval ship construction. One of these, the Bethlehem-Sparrows Point Yard in Baltimore, faced the prospect of closing its doors last summer. With contracts to convert 2 TAKX ships the yard is now able to preserve a nucleus of skilled craftsmen. It is essential to the industrial base of any yard in our Nation.

This will hold true for any other yard that may be engaged in construction of or conversion of these ships.

Mr. Chairman, I again want to thank you. I also hope you and the members of the subcommittee will look closely at the very most important nonfinancial advantages that I have attempted to convey to you this morning.

Again I express my thanks to you for permitting me to be here.

Mr. PICKLE. Thank you, Mr. Dyson, for your statement. I can appreciate your concerns.

Are there any questions by any members of the committee, Mr. Martin?

Mr. MARTIN. Thank you, Mr. Chairman.

It is nice to have you here, Mr. Dyson, to put a little different light on the whole subject to indicate there are some advantages.

You emphasized nonfinancial advantages but have you considered well perhaps there are some financial advantages in that fixed lease cost of these items may help avoid cost overruns?

Mr. DYSON. The information provided to us, Mr. Martin—I think you have probably seen some of this with the close attention that the Washington Post has given it in the last couple days—but even with the tax aspects and of course I realize that is the focus of the committee meeting this morning, the Navy anticipates saving $28 to $30 million per ship.

So we have seen that, yes, the other side of it, it provides a tremendous number of jobs almost immediately in some of our marginal shipyards.

Mr. MARTIN. Did your committee in its consideration of the subject here formally or informally attempt to assess what the tax effect of this practice would be?

Mr. DYSON. Well, obviously you know that is not—we did do some; yes. We had a number of hearings, Chairman Bennett conducted them on this. I think it is enough—enough assurance was given that this would not be abused. I am really not prepared to say too much more than that this morning.

Mr. MARTIN. All right.

Let me ask you this: Did your committee think it would be desirable to appropriate the funds to purchase these ships?

Mr. DYSON. I can only say that we are looking into that, yes.

Mr. MARTIN. But the committee had not reached a decision to recommend that in legislation to purchase the ships?

Mr. DYSON. No.

Mr. MARTIN. But would allow them to lease because it would appear to have a lower price?

Mr. DYSON. Yes.

Mr. MARTIN. Thank you.

Mr. PICKLE. Would the gentleman yield?

Mr. MARTIN. Yes, indeed.

Mr. PICKLE. You are saying that your subcommittee even at this date is recommending appropriated funds for these cargo ships. Does that mean you think something might happen to this contract and you are considering it?

Mr. DYSON. I have been given better information, in 1982 we did authorize the appropriation of some and then subsequently that was reversed. So I think that that might clarify just a bit.

Mr. PICKLE. That was used up in other categories.

My question to you is, are you holding hearings and are you contemplating recommending appropriated funds for the construction of these cargo ships and if you are, are you then assuming that something might happen to this contract yet?

Mr. DYSON. I have been informed that that is not an issue addressed in the hearings. We are not recommending that.

Mr. PICKLE. Thank you, Mr. Dyson.

Are there any other questions?

Mr. DORGAN. Mr. Chairman, yes; just one.

Mr. PICKLE. Mr. Dorgan.

Mr. DORGAN. The issue as I hear you explain it is a jobs issue, in some respects at least. I do not think anybody——

Mr. DYSON. I think a military one, too, very important to the Sealift Command.

Mr. DORGAN. The question of whether we need sealift capability for the Rapid Deployment Force is a question that should be answered on its own merits without respect to the financing efforts. I think everybody in the committee understands that. The question here is when we make a selection of new ships for sealift capability, in this case, the TAKX prepositioned ships, do we want to select a method of financing that will cost the American taxpayers 12 percent more than if the American taxpayers were to purchase those ships?

You talked about abuse of the lease approach. It seems to me that on the front end there is an abuse if, in fact, this arrangement asks the Government to use ships in a way that will cost the American taxpayers 12 percent more than if they purchased the ships outright. I understand the jobs issue and the military issue. I am saying that that ought to be set aside. The question is, is it not stupid for this Government to look at an arrangement that asks the taxpayers to pay 12 percent more for ships rather than what we would have paid had we purchased them?

Mr. DYSON. The subcommittee I am not on, but chaired by Mr. Dan Daniel of Virginia, looked into that question, and in correspondence and in debate in the committee directed the Navy to come forth and indicate that there would be a savings taking into consideration these tax advantages that you mentioned.

Mr. DORGAN. They directed the Navy to indicate there would be a savings?

Mr. DYSON. Excuse me, they directed the Navy to take it into account.

Mr. DORGAN. I think it is clear there are not savings. In fact, I think it is clear we begin this process with a 12-percent overrun, 12 percent more than the ships should cost the Government. That is where we start. From the standpoint of the Armed Services Committee, the Ways and Means Committee, from the standpoint of the U.S. Government, that is a foolish position to start from.

Mr. DYSON. Again, I can only go back to like I said, Mr. Daniel's subcommittee in writing this came up with the conclusion that in fact it was cheaper.

Mr. DORGAN. I understand your point on the military need and jobs. I think all of us agree that you make decisions on those two issues on their merits. But with respect to the financing, this hearing is important to clarify what these ships will cost the taxpayers.

It appears to me that it will cost the taxpayers more money, and with the debate we have on defense costs going on today, we shouldn't be deciding at the front end that we will spend 12 percent more to get the job done.

I appreciate your testimony.

Mr. DYSON. Thank you.

Mr. PICKLE. Thank you very much, Mr. Dyson. We appreciate your appearance before the committee.

Now the Chair will ask Mr. Dave Brockway, who is the director of the Joint Tax Committee, to take his place at the witness table. This is a departure from the scheduled number of witnesses. We felt that it might be important because of the great interest that has been generated in this inquiry, for the Joint Tax Committee to factually lay out for us the development of the various steps that brought us here to this inquiry today.

I would want to say to you, Mr. Brockway, that the Joint Tax Committee has done an excellent job in preparing this committee print, "Tax Aspects of Federal Leasing Arrangements." In my opinion this is a very valuable document. I think it would be useful in answering the many questions we have. It is a thorough and accurate analysis, and I commend the staff for the publication of it.

The Chair will ask you to make such comments of facts that you wish to present to the committee before we proceed with the witnesses.

STATEMENT OF DAVID BROCKWAY, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION

Mr. BROCKWAY. Thank you very much, Mr. Chairman.

Thank you for your comments on the study. The study was the work of a number of members of the staff. The economic analysis was coordinated by Ken Wertz on my left, and the legal analysis by Rich Mull, on my right.

I thought I would first go through the factual background, as we understand it, of the TAKX maritime prepositioning ship program, the legal analysis contained in the study, and then the methodology we used to reach our conclusions as to the tax cost of this program.

We are only in a position to discuss the tax implications of whether the ships should be acquired through lease financing or acquired through outright purchase. There may well be factors that indicate that leasing might be more advantageous than acquisition, other than those that we are capable of addressing.

To begin with, the ships are intended to be used in the sealift support for the Rapid Deployment Forces. There are 13 rollon/rolloff transports. These ships, while they could be used as commercial cargo transports, have been substantially modified to be of particular use in the support of the Rapid Deployment Force, so they are probably best looked at as military ships, not general-purpose cargo ships for commercial purposes.

The cost of each ship if purchased outright is $178.2 million, or roughly $2.3 billion for all 13 ships.

Evidently the original plan when the Navy decided to acquire these ships was do it through outright purchase rather than lease finance.

Approximately a year ago, however, the Navy concluded that it might be better to lease the ships rather than to purchase them. As discussed earlier, there were a variety of budgetary reasons why they thought that might be appropriate, and the documents also make it clear that the Navy was of the opinion that it would be of lower cost to the Government if they were to lease the ships than to purchase them outright.

As I will get to in a moment, that is a conclusion we do not agree with. That evidently was their opinion, however.

They also had made clear to the authorizing and appropriations committees their intention to go forward with the lease financing. It was done so on the assumption and understanding that it would result in a lower aggregate cost to the Government.

The facts—because of the Navy's desire to get the maximum possible tax benefits—are fairly complicated in these transactions. They are structured in the form of leverage leases where there is a private shipowner who leases the ships to a private ship operator, who then provides transportation services to the Navy.

It is our understanding that there is a separate shipowner for each of the ships. The owners are partnerships, presumably made up of corporations. In the contract that we used as a model, a partnership was set up solely to own this particular ship. Its name is the Marine TAKX-3 Co., which is described as a partnership of certain present and future equity owners. These partners are intended to be the owners of the ship for tax purposes. We do not know who the partners are. We discussed it with the Navy, and they indicated that there might be some business confidentiality reasons why the identity of the owners should not be disclosed. In any event, I understand it may be that the particular partners for this transaction have not yet entered the partnership. So it is only in the future that we will find out who the ultimate owners are intended to be for tax purposes.

The dummy corporation that Senator Metzenbaum referred to would, I believe, be one of two parties that would act together as the operator of the ship. They are to take the ship under lease from the owning partnership and provide the services to the Navy.

One of the parties is a contractor who contracts with the Navy to provide the services under this agreement. That is the corporation that was set up solely for purposes of this transaction. I believe the one we looked at was the Export Transport Corp. That is a subsidiary of the actual operator of the ship, which is the Maersk Line Ltd., which is a Delaware corporation. That I gather is a subsidiary of a larger group; I am not sure where exactly it is based.

In any event, the operators are not the same on all the ships. Maersk operates some; Waterman Steamship Line is another one of the operators for certain of the other ships; and the third operator is General Dynamics, I believe. They crew the ships, with members that are appointed subject to Navy control or approval in certain circumstances; and they provide the transportation services that the Navy desires.

The contract term is 5 years, with four 5-year renewal periods. The way the contract is structured, it is virtually certain that it would be renewed. It would probably be best, therefore, to view it as a 25-year lease of the ships to the operator, and then a 25-year service agreement with the Navy, but a service agreement that the Navy can cancel at its convenience after the first 5 years. Upon cancellation, it must pay the fair market value of the ship to the operator, or if it is higher because the ship declines more rapidly in value than anticipated, it has to pay off the unamortized principal and interest on the indebtedness incurred by the owner, and also it has to pay off the equity of the shipowners, including their guaranteed rate of return.

The Navy makes its payment for the ships two ways. First it makes a capital-hire payment. This covers the after-tax costs of the shipowner, comprised of its equity investment on which it is guaranteed a 11¾-percent after-tax rate of return, plus the debt service, both principal and interest, on the financing that the shipowner itself obtains. From what we understand, the shipowner will provide about $70 million of equity for each ship, and will go out and borrow on the security of the ship another $110 million. So, that the capital-hire payments are to cover the $70 million equity with the guaranteed rate of return plus the debt service on a $110 million indebtedness.

The other portion the Navy pays is an operating hire payment, which is to cover the cost of the operators of the three companies, plus their profits.

While the transaction is structured in the form of the provision of services to the Navy by these operators, in fact the Navy assumes a number of the risks that it would assume if it were the outright purchaser of the ships. One, the Navy is subject to the risk of damage or loss of the ship other than by negligence of the operators of the ship; two, through the way the transaction is structured, the Navy is subject to the risks that the ship may decline in value faster than the amortization of the debt and equity provided in the agreement; and, three, the Navy's payments are subject to the risk that financing will be at whatever interest rate the owner can possibly get. The Navy will reimburse the operator for whatever its financing costs are.

Also, under the agreements the operating hire payments will be adjusted to reflect certain price fluctuations in the operating expenses, so the Navy will pay what it costs the operator to operate the ship. So it bears the risk that those expenses will vary.

Finally, as discussed earlier, the Navy bears certain tax risks under the agreement, particularly that the investment tax credit will not be allowed because of the fact that the ship might be interpreted as being used by the Navy rather than the transaction interpreted as involving the provision of services to the Navy.

Also, as mentioned earlier, the Navy bears the risk that the tax laws may change. If they are changed in a way adverse to the owner of the ship, the Navy would be in a position of having to reimburse the owner for that loss of tax benefits.

As far as we are aware, there have been no opinion letters by counsel as to whether the transaction qualifies for lease treatment or whether it qualifies for investment credit or other intended tax

benefits; at least they have not been made available. As far as we are aware, there has been no ruling by the IRS indicating that it qualifies for the desired benefits under the Tax Code.

I do not think that, without further information and without seeing the actual bareboat charter between the owner of the ship and the operator, it would be possible to make a clear statement as to whether the transaction would qualify for the desired tax benefits.

The first legal issue is whether or not it is a valid lease, whether the shipowner would be treated as the owner of the ship, having a depreciable interest in the ship for tax purposes, so it would have the desired tax benefits. For tax purposes it is the substance of the agreement, not the form, that governs, so even though it is structured in form as being owned by the partnership, it is the substance that controls. This is decided on a case-by-case basis on all the facts and circumstances. The law in this area is not very clear. Our report describes certain of the precedents in the area, certain cases, and rulings that might give guidance as to how that would be viewed, but in our investigation we saw no direct and clear precedent for a structure such as that involved in this transaction, so it is very difficult to tell clearly whether or not this would qualify for lease treatment.

I should point out that on this issue, whether or not it is a lease, there is no indemnification of the shipowner as far as we can understand in reading the contract. If the IRS looks at this transaction and decides that the substance is really that either the Navy or the operator is the true owner of the vessel, not the purported shipowner, then as far as we understand the documents, the Navy would not be required to reimburse the owner for the loss in tax benefits.

Chairman RANGEL. Some of the members want clarification. You are saying in the lease agreement that if the IRS declares that the Navy is not a lessee, but is in fact the owner, that there is no financial obligation running from the Navy to the owners-investors?

Mr. BROCKWAY. As best as we understand the documents, if the transaction is attacked on the grounds that the Navy or the operator is the owner, and not the shipowner, then that loss of benefits on which the deal is structured would not be indemnified by the Navy. That is our understanding of the documents, Mr. Chairman, and we would just have to see what the Navy says. Our understanding is that there would not be a reimbursement in that situation.

The next item, even if the Navy is not treated as the owner and the operator is not treated as the owner, but in fact the partnership is treated as the owner of the ship for tax purposes and entitled to depreciation, there is a question of whether the investment tax credit is allowed.

Under the investment tax credit rules, the credit is not allowed where property is used by a governmental entity or tax-exempt entity. Where the property is used by an entity that does not pay tax, in general, no investment credit is allowed. That is the reason why this transaction was structured as a service agreement with the Navy rather than as a lease to the Navy or sublease to the Navy, so they could take the position that the investment credit

would be allowed. The argument is that there is only a service being provided and the Navy is not the user of the ship subject to the provision that denies the investment credit.

Now, that is again a facts and circumstances test. There is not clear, direct authority in point on this issue. I think it is very difficult, though, to read these agreements and come to the conclusion that the Navy is not a user of the ship, at least as the statute describes it. There have been certain rulings, however, that indicate that in some situations where the use has been predominantly by governmental entity, the agreement has been characterized as a service, and thus no investment credit disallowance was required. There is also a court case, the *Xerox* case, which extended the IRS ruling position significantly. In view of these precedents, there is at least some argument that the investment credit would be allowed, but I think it is fairly clear from looking at the documents that this case goes beyond any of those precedents and is closer to a situation where the Navy would be considered the user than any of those other precedents where the arrangement was characterized as the provision of a service and the investment credit was allowed.

However, this is the part of the contract where there is an indemnification, so that if the Service does challenge this treatment and takes the position that no investment credit is allowed because the Navy is the true user of the vessel, then the Navy is contractually obligated to reimburse the owner for the loss in tax benefits, and also for the costs of litigating with the Internal Revenue Service if that were to come to pass.

I am not sure in my mind whether that is such an abnormal provision to have in a lease. I know that, in safe-harbor leases that were entered into after the 1981 act, a standard provision in those leases was for the lessee to indemnify the lessor in case the desired tax benefits were not provided. I believe this is also standard in leverage leases such as this. I think that the issue that is different here is that I do not know what are the precedents for one branch of the Government indemnifying a lessor for a challenge by the IRS. But in tax-motivated leases between private parties these types of indemnifications are not unusual.

One final aspect of the transaction is that it appears to have been structured so the lessor of the vessel will be able to treat his income—in fact his loss, because the lessor will be taking a tax loss in the early years under ACRS—treat that as U.S.-source loss rather than foreign-source loss. That treatment preserves the lessor's foreign tax credit because the foreign credit is limited to the U.S. tax on foreign-source income. So if a loss does not count in computing foreign-source income, that maintains foreign-source income as high as possible, and maintains a foreign tax credit limitation as high as possible for the taxpayer.

As we can best understand the agreement, however, the operator would treat its income as foreign-source income, and it is unlikely to pay any foreign tax on this income. So you have a situation where by splitting up the activities between an owner and a provider of services, there is a maximization of the foreign-tax-credit position, and the operator may get to operate without paying tax on its operating profits, but the owner will not have to take the loss into account in computing its foreign tax credit.

The cost to the Government of leasing the ships is comprised of two separate parts. One is the capital-hire payment that will be paid on budget by the Navy; the other is the net income tax benefits that are allowed private parties in this transaction, but would not be allowed if the Navy were to own the ships outright. There is a third possible cost to this arrangement—the excess, if any, of the costs to the Navy by having the ships operated by a private party rather than by the Navy itself, but I understand that even if the Navy bought the ships they might well have hired an outside party to operate them. So, if that in fact is the case, it is difficult to see how that would be a cost attributable to the decision to lease.

I would like to turn to page 20 of our report that outlines the methodology we used to come to the conclusion that leasing would involve an increased cost of roughly $21 million per ship, the difference between the $178.2 million it would cost if the Navy purchased the ship, compared to what we compute to be a cost of $199 million in present value as these transactions are structured.

That would amount to a total additional cost to the Navy of $270 million for the 13 ships.

Looking at the chart at the bottom of page 20, the first item is the cost of a new ship, the $178 million it would cost the Navy if it were to acquire it but would not incur in the case of a lease. The next item is the approximately $130 million on a present value basis in rental payments that the Navy will be required to pay under the lease. Because those rental payments will be taxable income to the lessor, there is roughly $60 million in additional revenue to the Government on those rental payments, which leaves a net cost to the Government of a little more than $70 million. There is the tax benefit for ACRS and ITC which is a loss to the Government of roughly $80 million. There is a cost to the Navy of a used ship which it will purchase after the 25-year lease, or at least for this analysis it was assumed that the Navy would acquire it, which, after taking into account the recapture taxes, would be an additional cost to the Government of roughly $5 million. Then there is a $40 million cost of the interest deductions to the Treasury from the interest payments by the lessor-shipowner which would not have been allowed had the ship been owned by the Navy, because obviously the Government does not deduct its own interest costs. And the final item is the tax loss to the Treasury from the various fees paid the lawyers, investment bankers, and other intermediaries who will be compensated, and a tax deduction will be allowed for that compensation. That is $700,000 in present-value terms. So, netting it all out, the Navy saves $37 million by our analysis, the Treasury loses $57.8 million, and that amounts to a net loss to the Government of $20.8 million.

There appears to be some disagreement on how the tax costs should be analyzed. We are very comfortable with our analysis on how to determine what the true tax costs are. We have worked it over with the Treasury Department, and I believe that they think that our approach is a reasonable approach. I am not sure exactly whether they agree with it in every detail. I can say that the result is reaches does conform with what one might ordinarily think—since the Government enjoys the best credit rating of anyone in the economy, it is difficult to see how, by financing through a private

party that has to pay a higher credit cost, you could end up with a lower aggregate cost to the Government by routing it through a private financing entity.

There is another way to look at it which also gives some confirmation of that view. Under the transaction by its terms the equity is to receive a rate of return of 11¾ percent. When you take the residual into acccunt—the cost the Navy will have to incur to purchase the ship after the lease terminates, we calculate roughly a 14-percent after-tax cost to the Navy for leasing the ship. If you contrast that with the Government's borrowing costs of roughly 11 percent, something under 11 percent now on a long-term basis, that is some indication that a lease will be more costly in the aggregate to the Government than a purchase when the tax costs are taken into account.

In coming to the conclusion that it should lease rather than buy, the Navy relied on two consultant reports that we have looked at. In our opinion those reports used faulty methodology. The Coopers & Lybrand study came to the conclusion that there would be a tax cost to the Treasury on an initial look of a similar magnitude to the cost we suggest, but the study concluded that this should not be taken into account, or might not be, because those particular lessors might have entered into some other tax shelter and would not have paid any tax in any event.

We disagree that that is an appropriate conclusion. By deciding to lease rather than to buy, there are additional tax benefits created in the economy. Either those tax benefits would reduce the Treasury's revenue, or you have to reach the conclusion that the $2.3 billion of investment would totally replace private investment that would otherwise have occurred in the economy had the Navy decided to purchase the ship. Either way it is a cost to the economy, and so we disagree with that conclusion.

The other study, the Argent study, counted the tax cost to the Treasury Department, but counted as a plus the tax benefit that the Treasury would receive on the interest payments by each shipowner to its lenders. We believe that is incorrect, because even if the Navy decided to buy the ships, it would do that through borrowing, and that borrowing would be subject to tax, and so that by the methodology of the Argent study, we believe there is double counting.

We have had some informal discussions in the last week with the Navy Department as to the methodology to be used in costing these transactions. We are interested in and intend to continue to pursue those discussions. Perhaps there is some factor we failed to take into account in determining the costs. If we do have any change in methodology, we will report back to the committee.

With that background, Mr. Chairman, I think that the staff would now be happy to answer any questions on the transactions.

Chairman RANGEL. Thank you.

Is there any dispute that the cost to the taxpayer has increased under this method than if it was an outright purchase?

Mr. BROCKWAY. Well, I gather that the Navy disagrees with our analysis, and its consultants certainly disagreed. It disagreed in the past. I do not know whether after studying our analysis they now

agree with us in any way. At the moment, though, yes, there is some disagreement on that point.

Mr. PICKLE. Mr. Chairman, would you yield?

Chairman RANGEL. Yes, I yield.

Mr. PICKLE. The Joint Committee on Taxation makes the finding it costs $20.8 million more per ship. I understand that that is agreed to by the Congressional Research Service. As I understand your statement just a moment ago you said that you have given these figures to the Treasury. I think you used the phrase we have worked with the Treasury in this analysis, and you left the impression that they generally agreed. Specifically, have they disagreed with your costs, or do they seem to be in general agreement?

Mr. BROCKWAY. In our informal discussions they have not suggested that our approach was incorrect, but I think it is best, since Treasury will testify later this morning, that they comment on whether they believe this is an appropriate way to measure the tax cost.

Mr. PICKLE. Thank you, Mr. Chairman.

Chairman RANGEL. Thank you. Let me just ask a couple questions here.

While it may not be unusual to have these indemnity clauses in commercial agreements, this situation is unique. If there is any controversy as relates to IRS rulings denying tax benefits the Treasury Department may have a policy difference with the Navy, but the Navy will in fact indemnify its private lessors for whatever losses. Is that correct?

Mr. BROCKWAY. Correct.

Chairman RANGEL. Even though the clauses may be similar to agreements in the private sector, here we are actually dealing with different departments in the Executive branch of the U.S. Government having a dispute. The private parties do not lose no matter who wins the policy debates

Mr. BROCKWAY. That is correct. If they did not have the clause, then what would have happened is that, because the risk is clearly substantial—I do not think that anyone would disagree that there is a substantial risk that the ITC would not be allowed—the lease payments would have been higher. So perhaps what was happening was just an understatement of the on-budget costs of the transaction.

Chairman RANGEL. In your analysis of the actual ownership you stated at this time we may not know who the true owners of the vessels really will be. Does that mean we would not know whether there will be foreign owners of the vessels. Is that correct?

Mr. BROCKWAY. As far as we understand. We do not know who the owners are, and there does not appear to be any limitation on who the owners might be. I doubt that you would have a foreign owner here because the owner would be entering into the transaction to secure the tax benefits, and they would have to have some U.S. tax liability that they are sheltering with the tax benefits in this transaction.

I think the more troublesome question in this connection is who the operators are. I'm not sure whether foreign ownership would have any impact on the services provided to the Navy because the owners retain very little interest whatever in the ship. They do not

have a possessory interest. The contracts last for 25 years, and the ships are really in the control of the Navy and the operators, not the owners.

It may well be that one of the operators is a foreign-based multinational. We have not been able to run that down. That may be more where the issue arises.

Chairman RANGEL. But it is possible in your study of the lease agreement that if in fact these ships were deployed on a national security mission by the President, that indeed we could end up in court if the owners objected?

Mr. BROCKWAY. I would hope that the Navy will be able to address this arrangement more fully from that standpoint. From our understanding, the Navy, if it was not satisfied with the services provided by the operator, would just substitute a new operator, and that any disagreement would be resolved after the fact in court.

Chairman RANGEL. We are talking about rapid deployment, though.

Mr. BROCKWAY. My understanding is that at least the senior personnel are approved by the Navy. I would assume that the Navy is going to have day-to-day control over how the ships are deployed, and that any resolution of that issue would come after the fact. I think the Navy would be better able to answer that.

Chairman RANGEL. Thank you.

Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Pickle first, excuse me.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Brockway, all through your statement you have made certain observations that indicate you may have some question about this procedure yourself. You said first the ships were military—not combat, but they are military ships. And they are leasing this piece of property.

You said regarding the study made by Coopers & Lybrand that there is much with which we do not agree. You had some reservations about their conclusions.

You said it was a 25-year lease, really, not just a 5-year lease, as the Navy believes. In fact, you say it is a 25-year lease rather than 5, no matter what they labeled it.

You said that there was a question on foreign tax sources; that there might be a foreign government involved, and that we might not get any income involved from the foreign sources.

And there were other statements.

All this leads me to the belief—even to the extent you said the first lessor operator was a dummy corporation—that is what Senator Metzenbaum said, anyway all this leads me to think the Joint Tax Committee has serious reservations about this whole procedure. Is that an accurate observation?

Mr. BROCKWAY. I think the question is larger than solely the tax issues as to whether it makes more sense to proceed through a leverage lease than otherwise. I do think at a minimum, Mr. Pickle, that the committee should seriously consider whether to have the full committee or the Appropriations Committee, or whatever the appropriate bodies might be, to agree upon a methodology to determine what the true tax costs are of leased property.

Mr. PICKLE. Set up a methodology we do not have now; is that correct?

Mr. BROCKWAY. That is correct. So the tax costs are properly taken into account for budgeting purposes.

Mr. PICKLE. I have two specific questions. One, do we know who the owners are, the equity owners? You say we do know one, General Dynamics.

Mr. BROCKWAY. No; they are the operator of the ship.

Mr. PICKLE. They could be.

Mr. BROCKWAY. Right, the owner is a partnership, but we do not know who the partners are.

Mr. PICKLE. We do not know who the equity owners are, it could be General Dynamics, it could be a bank, insurance company——

Mr. BROCKWAY. That is correct.

Mr. PICKLE. But I am leading to the question, could it be a foreign source? Could it be another government? Saudi Arabia, for example, Kuwait?

Mr. BROCKWAY. It could be, under the agreements, but it is very doubtful, because the sole reason for structuring the transaction this way is the tax advantages. The reason to provide ownership in this partnership is that the owners, whoever they may be, have a tax base, a U.S. tax base, that they want to shelter. So, for example, Saudi Arabia would not have any U.S. tax liability, so they would not want to have the tax benefits.

Mr. PICKLE. I would think that surely would not be the case, either, that the tax responsibility or War Powers Act might prevent that.

Until we determine the owners, it seems to me these are serious questions. The problem is that this is interim financing, we will not know for another 12 months who the equity owners are. I think it is important to keep that in mind. There may be time to review the contract, I hope, at that point. Would that be an accurate appraisal?

Mr. BROCKWAY. As far as I can understand, the current state of affairs is that while we do not have equity owners involved in the transactions, the ships are under construction, so that the Government is going to end up, whether through the lease or acquisition, with the ships. It is that far along the line. Whether it is too far along the line to restructure it and have the Government own the ships rather than this partnership is quite another question. It may well be possible to restructure it.

Mr. PICKLE. Thank you.

Chairman RANGEL. Isn't it possible to have foreign equity owners of U.S.-based firms?

Mr. BROCKWAY. Well——

Chairman RANGEL. Certainly they would have a tax liability to the U.S. Treasury?

Mr. BROCKWAY. Yes.

Chairman RANGEL. So, when Mr. Pickle asks, you know, whether or not it could be foreign control, if they control the U.S.-based firm, could that not occur under this contract?

Mr. BROCKWAY. If you have a foreign multinational with substantial U.S. operations, they conceivably could be a lessor. Obviously,

it would be owned by the U.S. subsidiary, but clearly the foreign parent would have substantial control.

Chairman RANGEL. Thank you. Mr. Martin.

Mr. MARTIN. In the appendix, you go through a discussion of a pretax and aftertax accounting method of arriving at the impact of the discounted present value in order to estimate what the constant dollar effect is of the tax benefits.

Which did you use, pretax or aftertax method?

Mr. WERTZ. Mr. Martin, the figures that were referred to on page 20 use the pretax method.

Mr. MARTIN. Is there any controversy as to whether the pretax or aftertax method would be used?

Mr. WERTZ. Yes; there is a preference among Government economists to use the pretax method.

Mr. MARTIN. Government what?

Mr. WERTZ. In the executive branch of the Government, there is a preference to use the pretax method since this is the way that expenditures are also accounted for.

If the ship had been purchased, they feel it is preferable to state $178 million rather than $178 million less any tax we may collect on the interest income from the debt.

Mr. MARTIN. Aftertax method, if you used that method, would that lead to a greater net cost value or a lesser value?

Mr. WERTZ. It would lead to a slightly larger cost.

Mr. MARTIN. Using the pretax method gives the Navy the benefit of the doubt?

Mr. WERTZ. Yes, sir, in this case, but the answers are very close in both cases.

Mr. MARTIN. In the testimony that we will later receive from Deputy Assistant Secretary of the Navy, it indicates that there is some dispute as to whether certain tax receipts are considered in the OMB accounting procedures. How does that relate to the study which you did?

Mr. WERTZ. The tax amounts that are counted, both receipts and outflows, are unique to the lease, as opposed to the purchase.

Had the Government purchased, it would not have allowed itself cost recovery deductions or an investment credit, and so on.

On the other hand, had the Government purchased, there would have been interest income to the Government's bondholders, which could have been taxed. Tax on interest to debtholders is not in this list on the grounds that it would have occurred had there been a purchase or a lease; so, yes, there are tax items in here, but they are unique to the act of leasing as a means of acquiring the ship.

The items that are omitted are the items that would have appeared there, whether there had been a lease or a purchase.

Mr. MARTIN. No net effect?

Mr. WERTZ. Correct.

Mr. MARTIN. Is there any dispute as to the way in which you included those receipt items as opposed to the way the Navy did?

Mr. WERTZ. Yes; there is a difference. The principal difference would be that in this table on page 20, there would also be a positive item for the Treasury constituting the tax on interest income——

Mr. MARTIN. To the lender?

Mr. WERTZ. That is the one that we believe should not be there. That is the largest item that we believe should not have been included in the table.

Mr. MARTIN. You are showing interest deductions?

Mr. WERTZ. Yes; we are. Those are interest deductions which again are unique to the technique of leasing; that is, the lessor is paying interest and claiming interest deductions.

The Government, had it borrowed, would be paying interest, but would not be according itself tax deductions.

Mr. MARTIN. Would it be at the same rate of interest, making an adjustment for the different rate of interest that these borrowers would qualify for?

Mr. WERTZ. Yes, sir; generally one wants to do that. We did that, although the difference is very small in this case.

Mr. MARTIN. Well, a couple percent on several hundred million dollars could amount to some real dough.

Mr. WERTZ. Yes; it would. The Government is in the superior credit position.

Mr. MARTIN. Therefore, paying a lower rate of interest, and, therefore, those earning it would be earning a lower rate of interest and paying less tax than the tax paid by the lenders in the leasing arrangement?

Mr. WERTZ. Yes; in this case, however, the interest rates were very close; that is, the assumed interest rate in the agreement was very close to the current yield on new 30-year Government bonds. That is why I said in this case it made a very small contribution to the result.

Chairman RANGEL. Mr. Dorgan?

Mr. DORGAN. I have been looking at the study that the consultant provided the Navy on this issue. It is another lesson in the use of consultants, and some of us have a suspicion that when someone makes a decision, one way to provide protection for the decision is to ask for a consultant to give you a report.

Here in the introduction, the consultant was engaged by the Office of the Assistant Secretary to review certain financial implications of a proposed convert-and-charter program. Under this program the Navy would contract and lease existing vehicles.

So, this consultant apparently came in after an initiative was underway; at least they are talking about this kind of a lease program. The consultant is asked, what do you think of this?

The Navy wished to determine whether the costs to lease the vehicles would be less than the cost of direct purchase.

The consultant at that point analyzes that the lease payments, coupled with the tax losses, would be greater than the cost of outright purchase of the ships, except that the consultant conveniently argues that the tax revenue losses should not be part of the cost of the charter program for two reasons, one of which is an understandable reason, but erroneous, and the second is a comedy of confusion.

This raises the whole issue once again of using consultants to ratify decisions someone has already made.

The testimony that you have given has been excellent and provides a good framework for further discussion.

Thank you, Mr. Chairman.

Mr. PICKLE. Mr. Chairman, before we get the first witness, and I know we are running a little slow, I wish to make sort of an appraisal here.

It may sound like it is kind of light hearted, but it isn't, because we need these ships.

I am trying to analyze; going all the way from the Navy as a lessee to the lessor/operator to the contractor, over to the bondholders, to the financing agents and to the equity owners, I have kind of a summation that is appropriate.

The shipowner gets a 14-percent after-tax return, based on his profit, his ACRS, the investment tax credit, and the residual value of the ship.

The contractor gets the profit from the construction of the ship. There may be some refinements on my summation.

The lessor/operator, this dummy management, gets the fee for managing the lease. The finance agent, Merrill Lynch or Hutton, or whoever, get fees and commissions for the sale of the bonds.

The bondholders get a 11-percent-plus interest on long-term bonds.

The Navy, although they pass a lot of benefits over to others, the Navy gets the service of the ship. These are all good things. They are a kind of a gold mine.

What does the Treasury get? If the other's get the gold mine, the Treasury gets the shaft!

Chairman RANGEL. Thank you, Mr. Brockway.

We also thank you for the report prepared by the Joint Tax Committee staff.

[The report follows:]

[JOINT COMMITTEE PRINT]

TAX ASPECTS OF FEDERAL LEASING ARRANGEMENTS

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS

ON FEBRUARY 28, 1983

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled a public hearing on February 28, 1983, on the tax aspects of Federal contract leasing arrangements. This pamphlet provides background information relating to tax aspects, governmental costs, and other policy issues concerning such arrangements, particularly with reference to the Navy Department's TAKX Maritime Prepositioning Ship program.

The first part of the pamphlet is an overview. The second part is a description of the Navy's TAKX ship program. The third part is a discussion of the tax aspects of the TAKX arrangements. The fourth part discusses the Government's cost of the TAKX arrangements, and the fifth part is a discussion of certain policy issues involved in leasing by nontaxable entities. Finally, an Appendix describes accounting methods for government leases.

I. OVERVIEW

Statement of facts: Navy's charter of TAKX ships

The TAKX Maritime Prepositioning Ships program has been authorized to provide sealift support for the rapid deployment of marine amphibious brigades to crisis areas. A TAKX ship is a built-to-purpose roll-on/roll-off container ship that can be loaded and unloaded in areas without port facilities.

The Navy's original proposal to procure the TAKX ships was replaced with a decision to charter them, according to which the ships are owned, operated and maintained by private parties. The staff understands that the Navy has committed to charter 13 TAKX ships, the aggregate cost of which would be approximately $2.3 billion if purchased outright.

The charter arrangement involves a shipowner, a contractor and the Navy. The shipowner arranges for the construction of the ship and leases it to the contractor. Then the contractor through an operating agent mans, equips and maintains a TAKX ship, transporting equipment, cargo and personnel for the Navy. Including options to extend, these services are to be provided for 25 years. For these services the Navy pays a capital hire, which covers the after-tax capital costs of the shipowner with a 11.745-percent guaranteed after-tax rate of return, and operating hire, which covers the costs of operating the ship and the contractor's profit. In addition, the Navy assumes economic risks of damage to or loss of the ship; risks that the ship will decline in value; and risks associated with interest rate and price fluctuations. The Navy is obligated to reimburse the contractor for disallowed tax benefits if the charter arrangement is treated as a lease for Federal income tax purposes, and the Navy will pay the shipowner's costs of contesting the disallowance.

The statement of facts is made in greater detail in part II.

Tax aspects of TAKX arrangements

The TAKX arrangement contemplates that certain tax benefits will be available to the shipowner as a result of its investment in the ships. These tax benefits include accelerated cost recovery (ACRS) deductions and an investment tax credit. Their availability is premised on a number of assumptions, including a basic assumption that for Federal income tax purposes the shipowner will be treated as the owner of the property. Although the documents indicate that the Navy is not intended to have an interest in the vessels themselves, the determination of which party in the TAKX agreements should be treated as the owner for Federal income tax purposes is based on the substance of the transaction and not just on the labels attached by the parties. If the Navy were considered to have acquired an ownership interest, no ACRS deductions or investment credit would be available.

If it is established the shipowner really owns the ship for tax purposes, there is a further limitation under present law that prevents allowance of the investment credit where property is used by a governmental unit. If the Navy's charter agreement were treated as giving the Navy the right to use the ship rather than a mere right to transportation services, this limitation would result in disallowance of the investment credit.

Under the TAKX arrangement, the Navy bears significant economic risks, which raises questions as to whether the shipowner will in fact be treated as the owner for Federal tax purposes and, thus, whether any of the assumed tax benefits will be available. Even if the shipowner were considered to be the owner of the ships for Federal tax purposes, the Navy may be considered the user of the ships, which would preclude the allowance of the investment credit.

Tax aspects of the TAKX arrangements are discussed in part III.

Governmental cost of TAKX arrangements

The Federal Government's capital cost of a TAKX arrangement has two parts: (1) capital hire paid on-budget by the Navy and (2) net income tax benefits allowed to private parties that would not have been generated under governmental ownership. The Navy commissioned two studies to examine these costs. Both concluded that chartering could be less costly, although in one study that conclusion required that tax benefits be disregarded.

The staff has developed a methodology for measuring the relative costs of chartering and purchasing a TAKX ship. This methodology was applied to the data presented in the one TAKX agreement that was made available to the staff at an early date. Analysis of that agreement indicates that the government will pay about $199 million in present value to charter a TAKX that it could have purchased for $178.2 million. The Navy will save an estimated $37 million in on-budget expenditures; however, there will be an estimated revenue loss of $57.8 million arising from the arrangement. The excess cost of chartering, $20.8 million, is thus estimated to be about 11.7 percent greater than the purchase price. Analysis of four additonal TAKX agreements subsequently made available suggests that the excess cost of chartering is, on average, approximately 11.7 percent greater than the purchase price of the ship. In general, it appears on theoretical grounds that the Federal Government, which enjoys the best credit, cannot gain by financing long-term capital projects through parties that require higher yields.

The staff's analysis is described in part IV; its methodology, in the Appendix.

Policy issues: Leasing by nontaxable entities

Behind the TAKX arrangement is a set of broader questions related to leasing by nontaxable entities such as Federal departments and agencies, State and local governments, nonprofit charitable and educational organizations, and foreign persons.

When a nontaxable entity leases an asset it might have purchased, Federal income tax benefits are generated for the lessor

and in part passed through to the nontaxable entity as reduced rents. Thus, organizations that pay no income tax, nonetheless, can enjoy the benefits of income tax deductions and credits, at the expense of the Federal Treasury.

This opportunity to obtain capital goods through leasing on terms more generous than strict tax exemption raises several issues. The first issue is the extent to which Congress should make this opportunity available to Federal units, State and local governments, other nonprofit organizations, and foreign persons, in light of projected budget deficits and other matters of policy. The second issue concerns the proportion of the Federal revenue loss that ultimately benefits the nontaxable organization and the proportion that benefits third-party intermediaries. For example, the staff's analysis of the TAKX agreement described in this pamphlet indicates that about 64 percent of the associated revenue loss will benefit the Navy and 36 percent will benefit third parties. The third issue relates to the proper functioning of the budgetary process, to the extent that the revenue loss of leasing to nontaxable entities does not appear, or is not properly accounted for, in the Federal budget. For example, a Federal agency or department could reduce the apparent short-run costs of its programs by committing to long-term leases, unless such commitments are clearly accounted for when made. The fourth issue relates to whether use of sophisticated, tax-motivated arrangements by tax-exempt entities creates perceptions that the tax system is unfair, especially if the Federal Government itself engages in the practice. The fifth issue relates to whether the quality of public sector services is affected by structuring their delivery to qualify for more favorable tax treatment. For example, performance by public employees may be deemed essential to the quality of certain public services and the accountability of their provision, yet be adverse to the tax-related interests of private parties who might provide the services through a lease arrangement.

These issues are addressed in part V.

II. STATEMENT OF FACTS: NAVY'S CHARTER OF TAKX SHIPS

The TAKX program was authorized in 1979 by the Secretary of Defense in order to provide sealift support for the rapid deployment of the marine amphibious brigades to crisis areas. The TAKX ships are built-to-purpose, roll-on-roll-off, container ships. The ships have self-sustaining capabilities to load and unload cargo in areas without port facilities.

Initially, the Navy proposed to finance, construct, and own the TAKX ships. Ultimately, the proposal to own the TAKX ships was replaced with a proposal to charter the required ships. The decision to charter ships was based on two studies, conducted on the Navy's account by a national accounting firm and an economic consultant, which concluded that the Navy could charter a TAKX ship for as much as 35 percent less than the cost of purchasing the ship.

Under the TAKX charter arrangement, the Navy has contracted for services to be performed by TAKX ships. The services to be performed are the transportation of equipment, cargo, and personnel on a time charter basis. That is, the TAKX ships are to be owned, operated, and maintained by private parties for the sole benefit of the Navy for a specified period of time.

The original proposal for the charter arrangement was unacceptable to prospective contractors because the proposal would have required the contractors to assume significant economic risks. While the structure of the original proposal was maintained, the final charter arrangement places significant economic risks upon the Navy, most of which are similar to the risks the Navy would have borne had it owned the ship outright.

Structure of the TAKX charter arrangement

The TAKX charter arrangement involves three primary parties: (1) the Shipowner, (2) the Contractor, and (3) the Navy.

The TAKX charter arrangement involves two basic agreements: (1) a lease of the ship under a Bareboat Charter between the Shipowner and the Contractor conveying use of the ship to the contractor, and (2) an agreement to provide ship transportation services under a Time Charter between the Contractor and the Navy. There is also a Credit Agreement, involving financing, and an Operating Agreement between the Contractor and a related party for performing the actual services.

The staff has obtained copies of an "Agreement to Charter" and a "Time Charter" (referred to collectively as the "Time Charter") relating to one of the TAKX ships. The staff understands that the Navy has entered into substantially similar arrangements with respect to all of the TAKX ships. The following description of a TAKX charter arrangement is based largely on this document. Related contracts for that type of ship (*e.g.*, the "Bareboat Charter,"

the "Credit Agreement," and the "Operating Contract") have not been examined yet by the staff.

Contractor arranges for ownership, financing, and contruction.—The documents indicate that the Contractor is responsible for arranging for the financing and construction of the ships. It is also responsible for obtaining the Shipowner, which will be a partnership comprised of equity investors.

Shipowner arranges for construction.—Once a Shipowner has been obtained, the Shipowner will contract for the construction of the TAKX ship in accordance with the Navy's specifications.

Shipowner leases to Contractor.—Once the TAKX ship is constructed, the Shipowner will convey the ship to the Contractor under the Bareboat Charter. The parties contemplate that for Federal income tax purposes the Bareboat Charter will be treated as a lease agreement under which the Shipowner is lessor and the Contractor is the lessee.

Time Charter to the Navy.—Under the Time Charter, the Contractor must provide transportation services to the Navy and ensure that the TAKX ship is manned, equipped, and maintained in accordance with the Navy's requirements. The parties contemplate that for Federal income tax purposes the Time Charter will be treated as a service contract and not a lease. Services will actually be performed by an affiliate of the Contractor (referred to as the "Operator") under a separate operating contract. In the event that the Contractor defaults, the Contractor will be required to appoint an "Operating Agent," who will assume possession and control of the ship and who will assume the right to payments made by the Navy. If the Contractor does not appoint an operating agent, the Navy may do so.

Pursuant to the Time Charter, the Navy is required to make two types of payments: (1) capital hire (which is computed by reference to the amounts required to repay—with interest or a return—the debt financing and equity investment of the Shipowner, taking into account the net income tax benefits for the Shipowner that are generated by the Bareboat Charter), and (2) operating hire (which covers the costs of operating the TAKX ship and the Contractor's profit). In addition to these basic charges, the Navy assumes a variety of other economic burdens described below.

Specific aspects of the time charter

Term of the Time Charter.—The Time Charter provides for an initial term of 5 years (referred to as the "Basic Term"). The Navy has the option to extend the Basic Term for one to four successive renewal periods, for a total of 25 years. The useful life of the ships is at least 30 years.

The Navy may not terminate the Time Charter for convenience during the Basic Term. However, it may terminate for convenience at any time during the renewal periods.

Manning.—The master, officers, and crew of the TAKX ship will be civilians hired by the Contractor, subject to the Navy's approval. All officers must be qualified for a United States Government "Confidential" security clearance. In addition, the Master, Chief Officer, and Radio Officer must be qualified for a United States Government "Secret" security clearance. The Navy reserves the

right to station approximately 28 "Permanent Government Personnel" aboard the ship. Also, the Navy has the right to assign up to 100 additional military personnel to the ship as a surge team.

Operating hire.—Operating hire is payable for each 24-hour day or part thereof during the 25-year extended term of the Time Charter.

The operating hire payments may be adjusted to preserve the basic economic assumptions (*i.e.,* to protect the Contractor's profit) and for other similar purposes.

Capital hire.—The Navy is obligated to make semi-annual capital hire payments. If payments of operating hire are suspended or reduced because the TAKX ship is not fully available for service, because the ship is in a reduced operational status, or the Contractor or Shipowner in any way fail to perform, the Navy must continue to pay capital hire during such period.

Improvements.—The Navy has the right to request the Contractor to make such improvements to the ships as the Navy deems necessary, unless those improvements affect the ship's seaworthiness. The work is to be done by the Contractor at the Navy's risk and expense. The improvements remain the property of the Navy. If the improvements affect the commercial utility of the ship, the Navy must remove them upon termination of the Time Charter and restore the ship to its prior condition.

The Navy's right to purchase the ship.—If the Shipowner finances the entire cost of the TAKX ship with debt (*i.e.,* if no equity investment is made), the Navy will have the option to purchase the ship (subject to Congressional authorization) at any time during the term of the Time Charter for a price equal to the principal amount of the Shipowner's debt financing plus accrued interest.

If the Shipowner has any equity investment, the Navy can purchase the TAKX ship at any time after the end of the Basic Term on any capital hire payment date. The price is fair market value, adjusted upward if fair market value is less than a fixed Termination Value (described below). The price is not adjusted downward if fair market value exceeds the Termination Value.

If the Navy makes an outright purchase of the TAKX ship, the Navy has the right to require the Contractor to continue to operate the ship at the same operating hire rates set forth in the Time Charter.

Economic risks borne by the parties

The Navy bears significant economic risks resulting from the acquisition and operation of the TAKX ship. The Shipowner is guaranteed an after-tax rate of return and is otherwise protected against the loss of its investment. The primary risks borne by the Contractor are limited to acts of negligence by the Contractor or its agents.

Risks associated with debt financing.—The capital hire payments are based on an assumption that permanent financing can be obtained at 11 percent. If the interest rate at which permanent financing is actually obtained is higher, the capital hire rate will be adjusted upward to reflect the higher interest rate. Thus, the Navy alone bears the risk that interest rates will rise.

Risks of damage to or loss of the TAKX ship.—Although the Contractor is required to secure full form marine insurance coverage, the costs of insuring the hull and machinery and the costs of protection and indemnity coverage are included in the operating hire rates and, thus, paid by the Navy. Further, the Navy must reimburse the Contractor for any increases in the costs of war risk insurance (including war risk insurance for the benefit of the Shipowner) after the first year of the Time Charter.

If the Contractor cannot obtain the required insurance, or if such insurance is not in effect for any reason beyond the Contractor's control, the Navy must reimburse the Contractor for any loss or damage arising during the term of the Time Charter, to the extent such loss would have been covered by insurance. Further, the Navy will reimburse the Contractor for any amounts that the Contractor is required to pay to the Shipowner as indemnities pursuant to the Bareboat Charter, to the extent not covered by insurance.

Upon the occurrence of an event of loss (which is defined in the Time Charter to include the actual or constructive loss, confiscation, or seizure of the TAKX ship), the Navy is obligated to pay any deficiency between (1) the Shipowner's unrecovered equity investment and remaining debt plus any tax liabilities arising out of the termination event (which amounts are defined as the "Termination Value" in the Time Charter), and (2) the insurance proceeds received by the Contractor.

Essentially, the Navy bears the risk that the required insurance will be unavailable and that the costs of such insurance will rise. More importantly, in the event that the insurance proceeds are not sufficient to make the Shipowner whole, or are not forthcoming, both the Contractor and the Shipowner can look to the Navy for indemnification.

Risk that the value of the TAKX ship will decline.—If the Navy exercises its option to purchase the ship at the ship's fair market value prior to the end of the extended 25-year term, the Navy will be required to pay any deficiency between the Termination Value (*i.e.*, an amount approximating the Shipowner's unrecovered equity, remaining debt, and any tax liabilities generated) and the value of the ship. The price is not adjusted downward if the fair market value exceeds the Termination Value.

If the Time Charter is terminated (for reasons other than an option to purchase) prior to the close of the 25-year extended term, the Contractor—with the consent of the Shipowner—can elect simply to retain the vessel. However, if the Contractor does not exercise this option, it must use its best efforts to sell the ship. If the Contractor is unable to sell the ship, the Navy is required to pay the Termination Value to the Contractor. Even if the ship is sold, the Navy must pay any deficiency between the Termination value and the sale proceeds. The Shipowner retains any excess of the proceeds over the Termination Value.

Thus, if there is a premature termination, the Shipowner retains the right to enjoy any appreciation in the value of the TAKX ship. The Navy bears the risk that there will be no market for the ship and the risk that the ship will decline in value. The purpose of the Termination Value payment is to ensure that the Shipowner at

least is able to recover its investment plus the specified rate of return.

The specified Termination Value of the vessel at the end of the 25-year term is almost nothing. At that point, the Shipowner will have been assured recovery of its investment plus a guaranteed rate of return. If the vessel has any value at the end of the 25-year term (and presumably it would, because the estimated useful life is in excess of 30 years), the Shipowner is entitled to that value in addition to its guaranteed return.

Risks associated with the characterization of the Time Charter for Federal income tax purposes.—The Navy is obligated to reimburse the Contractor for any amounts required to make the Shipowner whole if (1) the Shipowner suffers the loss of any tax benefits as a result of the Time Charter being treated as a lease for Federal income tax purposes, or (2) the Shipowner is required to include in gross income the value of any nonseverable improvements made to the ship at the Navy's request. The Navy can direct the Shipowner to contest any disallowance of tax benefits, in which case the Navy will also pay the costs incurred by the Shipowner in contesting such disallowance. The Navy is not required to indemnify the Shipowner for any loss of Federal income tax benefits attributable to characterization of the transaction as a conditional sale to the Navy.

The capital hire payments were calculated on the basis of the Federal income tax law in effect at the time the agreement to Charter was entered into. The Time Charter agreement made available to the staff was entered into before enactment of the changes made by the Tax Equity and Fiscal Responsibility Act of 1982, which, for example, reduced the cost of property eligible for ACRS deductions by one-half of the investment credit allowed (Act section 205). Thus, the Navy's capital hire payments already are subject to an upward adjustment.

Risks attributable to inflation and price fluctuations.—The operating hire payments are subject to economic price adjustments which, in effect, protect the Contractor against the risk that the operation of the TAKX ship will become unprofitable. Similarly, the capital hire payments and the Termination Value will be adjusted to preserve the economics of the transaction to the Shipowner. In no case will these amounts fall below the amount required to provide for a guaranteed "Nominal After-Tax Economic Yield" of 11.745 percent on the Shipowner's investment.

Risk attributable to alterations.—Any improvements to the ship are made by the Contractor at the Navy's risk and expense. If the improvements add to the cost of operation, the operating hire may be adjusted to take those additional costs into account.

III. TAX ASPECTS OF TAKX ARRANGEMENTS

Overview

The Time Charter contemplates that certain tax benefits will be available to the Shipowner as a result of its investment in the ships. In general, those tax benefits include accelerated cost recovery (ACRS) deductions and an investment tax credit. The availability of the ACRS deductions and the investment credit is premised on a number of assumptions, including a basic assumption that for Federal income tax purposes the Shipowner will be treated as the owner of the property. Although the documents indicate that the Navy is not intended to have an interest in the vessels themselves, the determination of which party in the TAKX agreements should be treated as the owner for Federal income tax purposes is based on the substance of the transaction and not just on the labels attached by the parties. If the Navy were considered to have acquired an ownership interest, ACRS deductions and investment credits would not be available.

If ownership were established in the Shipowner, there would be a further limitation that prevents allowance of the investment credit where property is used by a governmental unit (governmental use restriction). If the Navy's charter agreement were treated as giving the Navy a right to use in the ships rather than a mere right to transportation services, the governmental use restriction would result in disallowance of the investment credit.

What follows is a description of the present law rules bearing on these issues and a discussion of the application of these rules to the facts in the TAKX transactions. The last section discusses foreign tax aspects of the transaction.

The Ownership Issue

Business and tax reasons for leasing and similar arrangments

The traditional reasons for leasing and similar arrangements that permit companies to use equipment or obtain services without obtaining an ownership interest stem from tax, accounting, and a variety of business considerations. These considerations are discussed in the pamphlet, "Analysis of Safe-Harbor Leasing" (JCS-23-82), published in 1982 by the staff of the Joint Committee on Taxation.

Tax-exempt organizations and governmental units have leased equipment for many of the same tax and nontax business reasons as taxable entities. The recent increase in lease and similar arrangements by these entities is due in part to budgetary limitations on the purchase of equipment and limitations on the ability to issue tax-exempt bonds. These considerations are discussed more fully under Part V below. Also, as will be discussed below, the rea-

sons for arranging a transaction as a charter or service contract as opposed to a lease stem largely from the desire to avoid the government use restriction imposed on the investment credit.

Principles for determining ownership of property

Depreciation or ACRS deductions are allowed only for assets used for a business or income-producing purpose. Those tax benefits are viewed as a means of recovering the costs incurred to produce taxable income. In general, those tax benefits are not allowed to tax-exempt organizations or governmental units that have no taxable income.

The determination of ownership of property requires a case-by-case analysis based on all facts and circumstances. Although the determination of ownership is inherently factual, a series of general principles is embodied in court cases, revenue rulings, and revenue procedures. Most of those principles center on the question of whether a transaction structured as a lease or similar arrangement is in fact a conditional sale or financing arrangement that conveys an ownership interest to the user of the equipment. These general principles are described fully in the pamphlet, "Analysis of Safe Harbor Leasing" (JCS–23–82) published by the staff of the Joint Committee on Taxation.[1]

In general, for a person to be considered the owner of property for Federal income tax purposes, the person must hold title to the property under State law. State law ownership is not sufficient, however, to guarantee tax ownership, and both the courts and the IRS focus on the substance of the transaction rather than its form. The courts do not disregard the form of a transaction simply because tax considerations are a significant motive so long as the transaction also has a bona fide business purpose and the person claiming tax ownership retains sufficient burdens and benefits of ownership.

In general, the person claiming ownership must be the person who has an investment and suffers (or benefits) from fluctuations in value. Thus, if a lessee has the option to obtain title to the property at the end of a lease for a price that is nominal in relation to the value of the property at the time when the option could be exercised, as determined at the time the parties entered into the agreement, or which is relatively small when compared with the total payments required to be made, lease treatment is denied and the user is considered the owner.[2]

Recently, the Ninth Circuit in *Swift Dodge* v. *Commissioner*[3] held that a lease containing a terminal rental adjustment clause, which is used in auto leases to permit an upward or downward adjustment of the rent to make up for any difference between the projected value of the property and its actual value upon lease termination, was in substance a conditional sale to the lessee. The

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[1] The safe harbor lease provisions are not discussed in connection with the TAKX transactions. Those provisions, enacted in 1981 and modified in 1982 differ from the traditional lease rules basically because they permit lease treatment for transactions that have no purpose other than the transfer of tax benefits. The staff understands that the parties are not seeking benefits under the safe-harbor lease provisions.

[2] *See*, Rev. Rul. 55–540, 1955–2 CB.39 (and cases cited therein.).

[3] Docket No. 81–7440 (9th Cir., November 19, 1982), *rev'g* 76 T.C. 547 (1981)).

court concluded that where the lessee bears the risk of loss and risk of fluctuation in value, the only significant risk borne by the lessor is the risk of default by the lessee, a risk assumed by any holder of a security interest in a conditional sale.

IRS guidelines

To give taxpayers guidance in structuring leveraged leases (i.e., where the property is financed by a nonrecourse loan from a third party), the Internal Revenue Service in 1975 issued Revenue Procedure 75-21, 1975-1 C.B. 715, and a companion document, Revenue Procedure 75-28, 1975-1 C.B. 752 (the guidelines). If the requirements of the guidelines are met, and if the facts and circumstances do not indicate a contrary result, the Service will issue an advance letter ruling under the nonsafe harbor rules that the transaction is a lease and that the lessor is the owner for Federal tax purposes. The guidelines are not by their terms a definitive statement of legal principles and are not intended for audit purposes. Even if the requirements of the guidelines are not met, a ruling might be issued based upon the general principles described above.

The specific requirements for obtaining a ruling under the guidelines are as follows:

1. Minimum investment.—The lessor must have a minimum 20 percent unconditional at risk investment in the property.

2. Purchase options.—In general, the lessee may not have an option to purchase the property at the end of the lease term unless, under the lease agreement, the option can be exercised only at fair market value (determined at the time of exercise). This rule precludes fixed price purchase options, even at a bona fide estimate of the projected fair market value of the property at the option date. In addition, the lessor cannot have a contractual right to require the lessee to purchase the property (a put).

3. Lessee investment precluded.—Neither the lessee nor a party related to the lessee may furnish any part of the cost of the property. The rationale is that a lessee investment may suggest that the lessee is in substance a co-owner of the property.

4. No lessee loans or guarantees.—As a corollary to the prior rule, the lessee must not loan to the lessor any of the funds necessary to acquire the property. In addition, the lessee must not guarantee any lessor loan.

5. Profit and cash flow requirements.—The lessor must expect to receive a profit from the transaction and have a cash flow from the transaction independent of tax benefits.

6. Limited use property.—Under Revenue Procedure 76-30, 1976-2 C.B. 647, property that is limited to use by the lessee (limited use property) is not eligible for lease treatment. The rationale is that if the lessee is the only person who could conceivably use the property, the lessor has not retained any significant ownership interest.

IRS ruling regarding bareboat charters

The Internal Revenue Service has no published revenue rulings concerning the question of ownership in a ship charter arrangement. However, a private letter ruling (LTR 8126112, April 2, 1981), does address the treatment of a bareboat charter as a lease. The TAKX transaction involves a Bareboat Charter between the Ship-

owner and the Contractor. Private letter rulings are not legal precedents and may not be cited as such, but they are useful in determining how the Internal Revenue Service applies legal principles to a particular set of facts in the absence of other authority.

The facts.—In LTR 8126112, a vessel was acquired by a partnership. The vessel was financed in part (32 percent) by an equity contribution by the partners and in part (68 percent) by long-term bond proceeds issued by an owner-trustee and guaranteed by the United States under Title XI of the Merchant Marine Act. The owner-trustee held the vessel in trust for the owners and was responsible for executing all necessary documents.

Upon delivery, the vessel was to be chartered (*i.e.,* leased) for a basic term of 25 years, with options to renew at fair market value for three 5-year periods. The parties estimated that the useful life of the vessel was at least 33½ years, although the class life of the property under the Asset Depreciation Range (ADR) system is only 18 years. They also estimated that the residual value at the end of the 25-year basic lease term would be at least 20 percent of original cost.

The charter payments were sufficient to ensure that the owners would have a profit independent of tax benefits. In addition to the charter payments, the Charterer had to insure the vessel against loss and indemnify the owners against any loss, including any loss of the anticipated tax benefits. Upon loss, the Charterer had to make a payment equal to a stipulated loss value, taking into account payments by third parties. Any third party proceeds in excess of the stipulated loss value had to be split between the owner-trustee and the charterer in accordance with a formula. Upon payment of the requisite amounts, the ship had to be conveyed to the Charterer.

Although it is not clear from the facts in the ruling, it appears that the Charterer would be liable to make a Termination Value payment upon a premature termination of the charter under an arrangement similar to that used in the TAKX transactions.

Under the charter, the Charterer could make improvements to the vessel. Title to the improvements vested in the Charterer only if they were removable.

At the end of the lease term, the Charterer had the right to purchase the vessel at fair market value.

If at any time the Charterer defaulted, the owner-trustee could sell the vessel or require the Charterer to purchase all stock of the corporate partners who own the vessel for a price that would ensure the owners a set rate of return. The owner-trustee was secondarily liable. If both the owner-trustee and the Charterer failed to purchase the stock as required, a Guarantor had to make the purchase pursuant to a guarantee arrangement. Under a letter of credit arrangement, a bank might also be liable for the stock purchase price.

The ruling.—The Internal Revenue Service held in LTR 8126112 that the Bareboat Charter was a lease and that the partners were the owners entitled to depreciation and investment credit.

Application of rules to the TAKX transaction

Without the facts of the Bareboat Charter between the Shipowner and the Contractor, any discussion of the ownership issue in the TAKX transaction will be incomplete. Even if the bareboat charter agreement in the TAKX transaction were similar to that in LTR 8126112, that ruling cannot be used as a precedent. In addition, unlike the situation in the ruling, a third party is involved (*i.e.*, the Navy as Time Charterer) that bears significant economic risks.

Governmental Use Restriction on the Investment Credit

Overview

Property that is "used by" a governmental unit (other than property leased on a casual or short-term basis) is ineligible for the investment credit (sec. 48(a)(5)). It is clear that under the governmental use restriction the investment credit is unavailable with respect to property that is owned by or leased to a governmental unit. However, one court has held (and the Internal Revenue Service has ruled) that the investment credit can be claimed where the governmental unit essentially has contracted for a service to be provided by the owner of the equipment rather than for the use of the equipment itself.

Rationale for the governmental use restriction

When the investment credit was enacted in 1962, it was designed to stimulate expansion of the Nation's productive facilities by reducing the net costs of acquiring new equipment. At that time, the governmental use restriction was premised on the view that governmental demand for equipment is not dependent on its price. Thus, a reduction in price, which would, in effect, result if the investment credit were available, would not cause any corresponding increase in production.

A somewhat different rationale for the governmental use restriction is discussed in part V below.

"Service Contract" exception

Internal Revenue Service rulings.—Under Treasury regulation 1.48–1(k), "property used by a governmental unit" means only property owned by or leased to a governmental unit. In Revenue Ruling 68–109, 1968–1 C.B. 10, the Internal Revenue ruled that property provided to a customer as an integral part of a service is not "used by" the government within the meaning of section 48(a)(5).

Revenue Ruling 68–109 involved communications equipment installed by a public utility on the premises of governmental units. In ruling that the taxpayer's agreements with its customers were not sales or leases, but rather service contracts, the Internal Revenue Service relied on the fact that the taxpayer retained all ownership in and possession and control over the equipment. The Internal Revenue Service also focused on the fact that the communications equipment was part of an integrated network used to render

services to the customer, not property placed with a user to allow it to provide services to itself.

The Internal Revenue has issued a number of other rulings applying the service contract exception,[4] including a private ruling in which this exception was applied to the time charter of a vessel to the Federal government (LTR 8217040, January 27, 1982). Although a private ruling is not binding on the Internal Revenue Service or the courts, a private ruling is helpful in interpreting the law absent other authority.

LTR 8217040 involved a newly-constructed vessel that was to be time chartered to an agency of the Federal government. The basic term of the time charter was to be five years, with five one-year optional periods, for a total of only ten years. The taxpayer represented that it had to man, equip, operate, and maintain the vessel, and that the master of the vessel was to be under the direction of the Federal government as regards the employment of the vessel, but not as regards navigation, care, and custody of the cargo. The taxpayer also represented that it had to bear the risk of loss with respect to the vessel. The government reserved the right to choose the port-of-call and the cargo to be carried. The government also had to bear the expense of fuel and loading and discharging. If the vessel were "off-hire" because of any incident not within the taxpayer's control preventing the full working of the vessel, no charter hire would be required from the government.

The Internal Revenue Service ruled that the taxpayer could claim an investment credit for the vessel, based on the representations that the taxpayer had to retain possession and control over the vessel, that the taxpayer was required to provide maintenance and secure insurance for the vessel, that the taxpayer had to furnish and control the crew of the vessel, and that the time charter transferred no legal interest in the property to the Federal government.

The case law.—The only judicial decision dealing with the service contract exception to the governmental use restriction is *Xerox Corporation* v. *United States,* 656 F.2d 659 (Ct.Cl. 1981). In *Xerox,* a manufacturer provided duplicating machines to the Federal government. The Internal Revenue Service had issued a revenue ruling involving the same basic facts as in the *Xerox* case that held that the agreements were leases (Rev. Rul. 71-397, 1971-2 C.B. 63). The Court of Claims rejected the taxpayer's contention that its agreements were short-term leases, which are eligible for an exception to the governmental use restriction. However, the court held that the machines were eligible for the investment credit because they were provided as an integral part of a service contract.

Essentially, the Court of Claims based its decision on the Internal Revenue Service's own formulation of the service contract exception, as set forth in the holdings of published and private rul-

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[4] *See, e.g.,* Rev. Rul. 72-407, 1972-2 C.B. 10 (in which vehicles supplied to a governmental unit were ineligible for the credit because the taxpayer gave up possession of the property and placed it with the user to enable the user to provide services for itself); LTR 7847075, August 28, 1978, (in which the service contract exception was applied to a communications satellite system developed in response to a government bid request, based on the government's lack of possession and control, the fact that the taxpayer bore the risk of loss during the service period, and the fact that the system was available to commercial users).

ings (other than Rev. Rul. 71-397). The court rejected the government's contention that the service contract exception cannot ever apply where the customer's own personnel operate the machines, because this factor was present in the first ruling adopting the exception (i.e., Rev. Rul. 68-109, 1968-1 C.B. 10). The court emphasized that *Xerox* was not a case in which the cost or value of the property dominated the price of the total arrangement. The court also noted that, conceivably, its decision would be different if the Treasury regulation had formulated the precise confines of the service contract exception.

Although the published and private rulings do not articulate any single test for use in determining whether an agreement is a service arrangement or a lease, the court felt that the factors deemed common to service contracts in those rulings related to two broad areas of inquiry: (1) the nature of the possessory interest retained by the taxpayer, and (2) the degree to which the property supplied is a component of an integrated operation in which the taxpayer has other responsibilities.

In holding that the possessory interest retained by the taxpayer was not sufficient to constitute a leasehold interest, the *Xerox* court focused on the following factors which were drawn primarily from the Internal Revenue Service rulings in which a service contract was held to exist: (1) the taxpayer retained ownership of the machines, (2) the taxpayer decided whether to repair, replace, or alter the machines, and the customer was prohibited from altering or moving the machines, (3) the taxpayer bore the cost of adjustments, repairs, and replacements, (4) the taxpayer was responsible for loss or damage, except in the case of a customer's negligence, and (5) the presence of a 15-day cancellation provision placed an economic risk on the taxpayers.

In the second area of focus used by the Internal Revenue Service in determining whether an agreement is a service contract—the degree to which the property is part of an integrated operation—the court did not view as significant the distinction made by the Internal Revenue Service between property used by a taxpayer to provide services to its customers and property placed with the customer to allow it to provide services to itself. The court found that the integrated nature of the taxpayer's contractual arrangement was demonstrated by (1) the taxpayer's policy of making like-for-like exchanges of machines, and (2) the fact that the amount paid by the customer was primarily determined by the number of copies made.

Finally, in holding that the taxpayer's contractual arrangements could reasonably be deemed to be within the purpose of the investment credit, the court focused on the fact that the taxpayer manufactured machines for all customers not just the government, and that governmental use represented only 5 or 6 percent of the taxpayer's machines.

Application of the service contract exception to the TAKX charter arrangement

The TAKX charter arrangement raises several issues relevant to the determination of whether the investment credit will be available to the Shipowner. The allocation of rights and duties among the

parties to the Time Charter and the purpose for which the TAKX ship is required by the Navy may distinguish the TAKX charter arrangement from the cases that have been considered by the Internal Revenue Service and the Court of Claim under the service contract exception.

Thus, even if the Navy were not considered to have acquired an ownership interest, it might be considered the user of the ships which would result in disallowance of the investment credit.

Nature of the possessory interest retained by the Contractor.—The following facts distinguish the TAKX transaction from the *Xerox* case and relevant rulings with respect to the degree of possessory interest: (1) neither the Shipowner nor the Contractor bears significant economic risks, (2) the Contractor can be replaced under circumstances in which the Time Charter continues, (3) in the event the Navy exercises its option to purchase prior to the end of the Time Charter, the Navy can require the Contractor to continue to operate the ship under the same terms as set forth in the Time Charter, (4) that the Navy can cause alterations to be made to the TAKX ship, and (5) the Time Charter contemplates that the Navy will have the services of the TAKX ship for substantially all of its useful life. These facts are an indication that the Navy has acquired a significant possessory interest in the TAKX ship.

The possibility that the Navy may have acquired a significant possessory interest is also indicated by the nature of the TAKX Program. Should the TAKX ship be required for military use in a time of conflict (the Time Charter is unclear on this point), it may be argued that the ship will be under the control of the Navy.

Integrated nature of the arrangement.—In contrast to the *Xerox* case, in which the taxpayer made periodic like-for-like exchanges of the machines, the Contractor providing the service (and not the vessel) under the TAKX charter arrangement could be replaced. Unlike the *Xerox* case, the capital hire payments are not based solely on the amount of services provided. Further, the continuation of capital hire payments during periods when the ship is not fully available for service and, conversely, the continuation of operating services in the event the Navy exercises its option to purchase, indicates that the service and the hire elements of the TAKX arrangements are separable.

Purpose of the investment credit.—In *Xerox*, the Court of Claims considered whether the allowance of the investment credit would run afoul of the purpose of the credit. The court focused on the fact that the taxpayer manufactured fungible machines for the use of governmental and commercial users alike in concluding that the government's demand and the taxpayer's traditional primary market were within the normal operations of economic incentives. In the case of the TAKX charter arrangement, TAKX ships are built-to-purpose solely for governmental use.

Foreign Tax Aspects

The characterization of the transaction can have a significant impact on the foreign tax credit position of the shipowner and the contractor. Under the Code, a taxpayer is generally permitted to reduce its U.S. income tax liability dollar-for-dollar by creditable

income taxes paid to foreign countries. This credit is limited so that the foreign taxes offset only the U.S. taxes imposed on foreign source taxable income.

The source of shipping income depends upon the characterization of that income as rental income (bareboat charter hire) or transportation service income, e.g., time or voyage charter hire. If the income is rental income it is foreign source income to the extent allocable to periods when the vessel is outside the United States and its territorial waters. If the income is payments for transportation services between points in the United States and points outside the United States the income would be allocated between U.S. source and foreign source by comparing costs incurred in the United States and costs incurred outside the United States. Therefore, in either case, if the vessels spend most of their time outside U.S. territorial waters, most of the income would be foreign source. Likewise, the related deductions would be foreign source. Accordingly, the tax benefits available to the lessor could reduce its available foreign tax credit.

However, under a special exception to the normal source of income rules, income and related deductions of a lessor of a vessel are treated as U.S. source income provided the vessel qualifies for the investment tax credit, is manufactured or constructed in the United States, and the lessee is a U.S. person (section 861(e)). If the shipowner is the owner of the vessel for tax purposes, and if the Navy has a contractual right to transportation services rather than a possessory interest, the shipowner's income might qualify for this exception. If the shipowner incurs a net tax loss on the transaction for a taxable year the shipowner could treat the tax benefits as U.S. deductions which do not reduce its foreign source taxable income and therefore do not reduce its available foreign tax credits.

In contrast to the shipowner, the contractor is taking the position that its income is transportation service income not lease income. Assuming this position is sustained, and assuming that the vessels are used primarily in foreign or international waters, most of the contractor's income would be allocated to foreign sources (see Treas. Reg. sec. 1.863-4). This allocation would increase the foreign tax credit limitation of the contractor. If the contractor has foreign tax credits sufficiently in excess of its U.S. tax on its foreign source income, then this increase in its foreign tax credit limitation would enable it to offset any U.S. tax imposed on the income from this transaction with these excess credits. As a result the contractor would pay no U.S. tax on its profit from the transaction and very likely would not pay any foreign tax either.

IV. GOVERNMENT'S COST OF TAKX ARRANGEMENTS

In this part, an estimate is made of the change in the government's capital cost of obtaining the use of a TAKX ship through the type of agreement entered into by the Navy rather than through a purchase. Solely for ease of exposition and without inference with respect to any of the legal issues discussed in part III, the agreement will be called a "lease" in this part and the shipowner and contractor collectively will be called the "lessor."

Economic reasoning leads to the conclusion that the government's capital cost is greater when it leases on a long-term basis than when it buys. When it leases, the government's capital cost consists of rental payments and net tax benefits to the lessor. For the lessor to be willing to enter into the lease, these rental payments and net tax benefits must be large enough to cover the lessor's capital costs, which are the following: the decline in the value of a ship as it ages, interest and principal payments to lenders for loans used to purchase the ship, a rate of return on equity provided by investors and used to purchase the ship, and fees paid to third parties for setting up and carrying out the lease. The market rate of interest paid by the lessor and the rate of return expected by its shareholders generally exceed the interest rate on government bonds, because of the government's superior credit. Therefore, when the government leases, it compensates the lessor for greater financing costs than the government would have borne had it borrowed funds and purchased the ship. Similarly, to the extent that extra fees are involved in arranging a sale and lease, and not merely a sale, the government compensates the lessor for expenses that the government would not have borne had it purchased the ship. Therefore, as a theoretical matter, unless the lessor miscalculates and charges unprofitably low rents, it should be expected that the government's capital cost will be greater when it leases a ship than when it buys it.

Two consultants' reports commissioned by the Navy contend that none of the tax benefits generated by a TAKX arrangement should be counted as a governmental cost of leasing. This argument, however, is erroneous. As explained in detail in the Appendix, consistent accounting for governmental leases requires that associated tax benefits be taken into account. The argument for not counting the tax benefits assumes that private parties would find an alternative means of sheltering their income from tax if the TAKX opportunity were not available. In effect, the argument assumes that the totality of investors, when presented with an additional profitable investment in TAKX ships, abandons or fails to start certain other investments which it also regards as profitable and would have carried out (but for the TAKX opportunity). The realistic response, on the contrary, is for investors to add the TAKX arrangements to the pool of profitable ventures to be undertaken. This increases the

total amount of tax benefits claimed for investments. But even if investors were to react as the argument assumes, it would mean that the tax benefits going to the TAKX program were crowding out investments in other sectors of the economy. This lost investment represents a social cost that is properly attributed to the TAKX program. Thus, in either event, net tax benefits to the Navy's lessor should be counted in the government's cost of leasing a TAKX ship.

The staff has developed a methodology for quantifying the change in the government's capital cost when a governmental department leases an asset instead of buying. The methodology is explained in detail in the Appendix below. This methodology has been applied to the data contained in one agreement relating to the TAKX ship identified as "Maersk vessel number three". This is the only agreement made available to the staff at an early enough date to permit the detailed analysis which follows. Subsequently, four additional TAKX agreements were received in time to make certain computations that also are reported.

The results of the analysis of one TAKX agreement are summarized in the table. Each of the items in the table is expressed in dollars of constant value, so that they can be compared directly. Specifically, dollars are of the same present value as when the lease begins or, in the alternative, the purchase is made. A discount rate of 10.25 percent per year was used to compute these present values. This means, for example, that a $1 rental payment due one year after the lease begins is equivalent to a 90.7-cents payment on the day the lease begins. The 10.25-percent discount rate is the rate that bidders for the contract were instructed by the Navy to use in their submissions (Amended Solicitation N00024-82-R-2051, Attachment D, p. 3), apparently with reference to provisions of Circular A-94 of the Office of Management and Budget.

The table is divided into three columns. The Navy account shows the change in on-budget capital outlays, over the useful life of the ship, when it is leased rather than purchased. The Treasury account shows the change in tax revenues when the ship is leased. The Government account is the sum of the Navy and Treasury accounts. It shows the total change in the government's capital cost for the ship due to leasing instead of buying.

In the Navy account, the government, by leasing, saves the cost of purchasing the ship. This amount, $178.2 million, does not include the additional $4.2 million in legal fees and other fees which were paid by the lessor for arranging the lease and which the lessor treats as a capitalized cost. Then, over the term of the lease, the Navy will pay capital rents amounting to $131.7 million in present value. Finally, in order to have the ship after the 25-year lease expires, as the government would if it had purchased the ship initially, the Navy will pay an estimated $9.5 million in present value to acquire the used ship. This estimate is based on an assumed inflation rate of 6 percent and a 1979 study of economic depreciation commissioned by the Treasury, which determined that 7.5 percent is the best estimate of the annual rate of decline in the market price of ships and vessels (measured in inflation-corrected dollars on a declining balance basis). Adding all items in the Navy

account, the leasing of this ship is estimated to reduce on-budget capital outlays by $37 million in present value.

In the Treasury account, leasing gives rise to income tax items for the lessor that the government would not provide to or assess against itself, were it the owner of the ship by purchase. The lessor is assumed to pay the top corporate tax rate of 46 percent. Thus, revenues are reduced by $81.2 million in present value for the 10-percent investment credit and cost recovery (ACRS) deductions allowed for the lessor's depreciable basis of $178.2 million. Solely for purposes of conforming with assumptions stated in the TAKX agreement, this assumes that the property is not subject to the general rule enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), that depreciable basis must be reduced by one-half the investment credit allowed (Code sec. 48(q)). An estimated $4.4 million of the ACRS benefit is recaptured when the government purchases the ship at the end of the lease. In addition, revenues are reduced in present value by $39.5 million for the lessor's interest deductions and by $0.7 million for the amortization of legal fees and other fees. Finally, revenues are increased in present value by $59.2 million for the lessor's rental income. Adding all items in the Treasury account, the leasing of this ship is estimated to reduce tax revenues by $57.8 million in present value.[1]

Combining the accounts, the leasing of Maersk vessel number three is estimated to increase the government's capital costs of having the use of this ship by $20.8 million in present value. That is, the government's cost of this leased ship is estimated to be $199 million, approximately 11.7 percent higher than its purchase price. Inclusive of the residual value of the ship at the end of the lease, the lessor's estimated after-tax rate of return on investment is estimated to be 14 percent.

CHANGE IN GOVERNMENT'S CAPITAL COST BY LEASING INSTEAD OF BUYING MAERSK VESSEL NUMBER THREE

[In millions of dollars in present value, discounted at 10.25 percent annually]

Item	Navy account	Treasury account	Government account
Cost, new ship	−178.2		−178.2
Rental payments	131.7	−59.2	72.5
Tax benefit, ACRS		81.2	81.2
Cost, used ship	9.5	−4.4	5.1
Tax benefit, interest deductions		39.5	39.5
Tax benefit, amortized fees		.7	.7
Total	−37.0	57.8	20.8

[1] To maintain comparability with the data contained in the Navy's agreement, the lessor is assumed to be 80-percent current in the payment of corporate income taxes for the taxable year. However, as a result of changes made in TEFRA, corporations in general must be at least 90-percent in these payments (Code sec. 6655(b)).

The staff also has applied this methodology to data contained in the four additional TAKX agreements which subsequently became available. Analysis of the four contracts indicates that the government's cost of leasing a TAKX ship exceeds the purchase price by 11.7 percent, on average. Using this average for the entire TAKX program implies that the government will pay an extra $270 million by leasing rather then purchasing,

Two consultants' reports relating to the lease-versus-buy decision were completed for the Navy in 1982 (Coopers & Lybrand, "Analysis of the Convert and Charter Program;" and Argent Group, "TAKX Maritime Prepositioning Ships, Relative Financing Costs of Charter and Purchase, Supplemental Report"). The Coopers & Lybrand study considered hypothetical acquisition costs, rents and other dollar values, apparently because the actual lease terms were yet to be decided. It found that the government's cost of leasing would exceed the cost of purchasing in every case for which both on-budget outlays and net tax benefits were computed. However, the study termed it questionable to count tax benefits as a cost of the leasing program, on the assumption "that if the Navy does not go forward with its charter program, private sector firms will simply find other vehicles for sheltering their income" (pp. B–1 and B–3). The invalidity of this conclusion has already been discussed above. Subsequently, the Argent study was completed, using acquisition costs, rents and other dollar values that apparently were much closer to the actual terms of the Navy's contracts. This study concluded that the cost of leasing, inclusive of net tax benefits, would be less than purchasing. However, the Argent study includes as a revenue gain from leasing the income tax on interest income to the lessor's creditors, who are assumed to pay the top corporate tax rate on the income. Correction of this double-counting—as interest income also would have been earned had the government borrowed to purchase the ship—would reverse the study's conclusion. (A consistent way to account for interest income is elaborated in the Appendix below.) Argent's methodology differs from the staff's approach in two other respects. First, Argent assumes that in present value the ship is worthless at the end of the 25-year lease. Second, it assumes that an amount equal to the lessor's additional legal fees for arranging the lease would have been paid by the government even if the Navy purchased the ship instead of leasing it.

V. POLICY ISSUES: LEASING BY NONTAXABLE ENTITIES

A. General Issues

As a general rule, nonprofit entities such as Federal Government departments and agencies, State and local governments, and charitable and educational organizations receive no benefit from cost recovery deductions or the investment tax credit because they are tax-exempt.[1] However, in some circumstances, the law permits taxable companies to purchase, and claim certain tax benefits on, assets which are subsequently leased to nonprofit entities. In these lease transactions a portion of the tax benefit available to the lessor is passed through to the nontaxable lessee in the form of lower rents. Thus, the leasing arrangement allows certain tax benefits to flow through to nontaxable entities which are not eligible for them on their own account. This can result in a negative effective tax rate on the assets leased by nontaxable entities because they receive many tax benefits but, unlike taxable entities, do not pay tax on the income generated by these assets. The issue here is whether persons leasing assets to nontaxable entities should be granted, from the standpoint of legal and economic policy, *eligibility* for tax benefits on the same basis as persons leasing to taxable entities.

In addition to the eligibility issue, leasing raises the question of *efficiency:* does leasing create an incentive for nonprofit entities to select the least costly method of procurement? Alternatively, does all of Treasury's revenue loss due to leasing end up benefitting the nonprofit lessee, or is some of the benefit dissipated in the form of private profits and legal and administrative expenses?

A third policy issue is the impact of leasing on the budget process. Lease procurements are accounted for differently than ordinary purchases on the books of many nonprofit entities. This may disguise the nature of the outlays and reduce *accountability.* The problem is not limited to nonprofit entities: leasing constitutes a significant source of off-balance sheet financing in the corporate sector. Typically lease obligations appear in the operating budget rather than in the capital budget, thereby obscuring the multi-year financial commitment of the lessee. The budget process may also be distorted to the extent that a portion of the capital cost of the leased asset is shifted from the lessee's budget to the tax account of the U.S. Treasury.

A fourth policy issue is that control over leased property may be sacrificed by units of government in order to qualify for leasing tax benefits. A leveraged lease is an extremely complex legal arrange-

[1] The law provides, however, that the unrelated business income of tax-exempt organizations is subject to the corporate income tax. Thus, an unrelated business of a tax-exempt organization is eligible for the investment credit and ACRS depreciation, and its income is taxed at the corporate rate.

ment involving numerous participants, including investment bankers, commercial banks, insurers, contractors, trustees, and investors, each with their own set of interests. Government lessees may not be able to guarantee that the leased property is at all times used in the public interest, and there is a risk of prolonged litigation to enforce contractual obligations. In the case of the TAKX program, for example, serious conflicts of interest could arise if the Navy required sealift support in a high danger area, because the ships are manned with civilian crews under the Time Charter Agreement.

Finally, leasing by Federal, State, and local government units may erode the public's confidence in the tax system. After the enactment of the safe-harbor leasing provisions in 1981, there was a widespread public perception that these provisions were unfair. Ultimately, these sentiments played a role in Congress's decision to phase-out safe-harbor leasing in the Tax Equity and Fiscal Responsibility Act of 1982. To the extent that government leasing appears to be tax motivated the public may question the equity of the tax system as a whole.

From the perspective of Congress, the relative importance of these issues varies according to whether the nonprofit lessee is: (1) a Federal department, (2) a State or local government, or (3) a charitable or educational organization. The remaining portion of this part is devoted to a brief analysis of leasing issues in the context of these three types of nonprofit organizations, and a discussion of possible reforms.[2]

B. Federal Government Departments and Agencies

From an economic viewpoint, the after-tax price of capital should not depend on whether it is used by the private or the public sector; otherwise, it is likely that too much capital will be used in the sector where the price is cheap, and too little capital will be deployed where the price is dear. An implication of this viewpoint is the principle of neutrality which states that the effective rate of tax on capital (and other income-producing factors) should be equalized across all sectors of the economy. Starting from this proposition, some have argued that the public sector should be eligible for the benefits of accelerated depreciation and the investment credit (either directly or through leasing arrangements) because the private sector receives these tax benefits. This argument, however, neglects the fact that private corporations pay tax on the income generated from capital investments while government agencies do not. By the principle of neutrality, if tax benefits are passed through to government agencies, then so too should the burden of the income tax. Private companies have a relative advantage only to the extent that the tax benefits exceed the tax burdens of capital acquisition.

In certain circumstances, however, the law does permit private companies to enjoy the benefits without the burdens of the corporate income tax. This situation arises when a company in a non-tax

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[2] The policy issues involved in leasing to taxable organizations are examined in, "Analysis of Safe Harbor Leasing," a report by the staff of the Joint Committee on Taxation, June 14, 1982, (JCS-23-82).

position, perhaps as a result of losses carried over from prior years, captures certain tax benefits by leasing from a taxable lessor. In the loss company case, tax benefits associated with a leased asset flow through without any offsetting tax liability on the income produced by the asset until the loss carryover is exhausted (if ever). As a result, long-term loss companies can achieve substantially negative effective tax rates by leasing.[3] Thus, the issue appears to be whether the government and other nontaxable entities should be put on the same footing as taxpaying corporations (by denying some tax benefits for property leased to them) or as loss corporations (by allowing full passthrough of tax benefits).

Another argument that has been made to justify government leasing is that it is more efficient than ownership. For example, a one day auto lease is presumably less expensive than buying a vehicle and reselling it the next day. To evaluate this argument it is useful to examine the nature of the service which a lessor provides. Four distinct services can be identified: (1) purchasing, (2) financing, (3) operating and maintaining, and (4) reselling. The relevant question is whether a lessor can perform these tasks at a lower cost than the government. To answer this question it is useful to divide leasing arrangements into two broad categories: long-term and short-term.

In a long-term lease, the lessee exercises continuous control over deployment throughout the useful life of the property; while in a short-term lease, the lessee controls the property for only a small proportion of its service life. If the property is useless to anyone but the current lessee, the lease must be long-term in nature. Examples include equipment which has been customized to the lessee's operation, or plant which is immobile (or movable only at high cost). On the other hand, property which can be used by a large number of lessees, is standardized in design, and relatively easy to transport, is more suitable for the purposes of short-term leasing. Examples include office equipment and automobiles.

As a general rule it is unlikely to be cost effective for the government to procure property through a long-term lease, since the lessor seldom has a cost advantage in any of the four tasks enumerated above. First, if the government intends to hold onto the property for its entire useful life, there are no reselling costs involved. Second, the lessor will generally have a purchasing cost advantage only in circumstances where he is a larger buyer than the government agency. Third, because of the government's superior credit, the lessor will almost never have lower financing costs. And, fourth, if the lessor has lower operating and maintenance (O&M) costs then the least cost option is likely to be to buy the property and to contract with the lessor only for O&M services.

Short-term leasing, on the other hand, may be cost effective for government agencies. Purchasing can be uneconomical when the government intends to use the property for only a small portion of its service life because the buying and reselling costs are written off over such a short period of use. However, even short-term leases

[3] See Jane G. Gravelle, "Safe Harbor Leasing Under the Economic Recovery Tax Act of 1981 and Investment Efficiency," Congressional Research Service, May 12, 1982; and "Analysis of Safe Harbor Leasing," a report by the staff of the Joint Committee on Taxation, June 14, 1982.

are not necessarily cost effective because lessors generally have higher financing costs than the government which are passed through (along with the lessor's profit) in the form of higher rental charges.

In the case of the TAKX program, the Navy has procured the use of 13 cargo ships, over a 25 year period, by means of a lease agreement described in the Charter Agreement. The Charter Agreement specifies that the Navy will control the deployment of these cargo ships over the lease period, and that the Navy has an option to purchase prior to the expiration of the lease term. The TAKX program appears to fall within the category of a long-term lease, as described above, since the ships are being built to the Navy's specifications, and the Navy intends to use the cargo ships over a substantial portion of their service life. Thus, by the foregoing argument, it is unlikely that leasing results in any cost advantage to the government relative to purchasing the ships outright. Whether or not private crews can operate and maintain these vessels at a lower cost than the Navy is a separate question. If private crews are cheaper, then the Navy's least cost alternative probably is to purchase the ships and contract out the O&M. (A detailed analysis of the excess cost due to the Navy leasing program is presented in part IV.)

An argument against leasing by government agencies is that it may distort the budget process. In the case of a Federal department, a multi-year procurement program is funded, at the start, by a budget authorization which appears in the procurement portion of the department's budget account. The actual cash expenditure in each year of the procurement program appears as an outlay item in the procurement portion of the budget account. If the department acquires the same property through a leasing arrangement, the authorization for cumulative lease payments does not appear as a separate item in the budget. The annual rental payments appear as an outlay item in the O&M budget rather than in the procurement account.

Leasing also distorts the budget process to the extent that procurement costs are shifted from the department's budget to the U.S. Treasury through reduced tax revenues. Since the portion of the department's procurement program paid for by reduced tax revenues to the Treasury does not appear as a separate budget item, the total government cost of procurement cannot be ascertained from the unified federal budget. In summary, leasing shifts the disbursement of funds from the department's procurement account to its O&M account, and from the department's budget to the tax account of the Treasury. These discrepancies between the budgetary accounting for procurement by purchase and by lease make it difficult to determine the true cost to the government of Federal department leasing programs.

Another argument that has been raised against government department leasing is that the department forfeits too much control over the project. In the case of a construction project, involving a substantial number of jobs, Congress may not be able to ensure that a portion of these jobs are created in areas of high unemployment if the department finances the project through a leasing arrangement. Another example is a defense agency lease of military

hardware. In the event of war, the interests of the lessor and the defense agency might differ considerably about the deployment of the property. Conceivably, a leasing arrangement could pose a serious threat to the national defense if leased hardware were needed in an emergency.

Finally, some assert that leasing by Federal government agencies reduces the public's confidence in the operation of the tax system. To the extent that large lessors are able to reduce their tax payments to the Treasury by engaging in leasing transactions, leasing may appear inequitable. Also it may seem improper for Federal departments to participate in tax-motivated leases. These perception problems could lead to lower taxpayer compliance.

C. State and Local Governments

In recent years there has been a large increase in the level of State and local government lease activity. This phenomenon may be due to the difficulty in passing bond issues and the abnormally high real interest rates which now must be paid on many municipal bond issues. Certainly, leasing by State and local governments raises the issue of accountability since it circumvents debt limitations and the bond referendum process. But the important issue, from the federal government's perspective, is the drain on the Treasury caused by this surge of State and local government leasing activity. Unfortunately, the proportions of the problem cannot be determined accurately at this time since no aggregate data exists on the level of State and local government leasing activity, or the terms on which these governments obtain lease financing.

Consider the case of a city government which wishes to acquire a new $4 million building to use as its city hall. The conventional procedure is for the city to hold hearings and to have a referendum on a $4 million bond issue. Alternatively, the city government could, without a bond referendum, enter into a long-term lease for the building, and use general revenues to pay rent to the lessor. Due to tax benefits, the present value of lease payments is *less* than the $4 million it would cost the city to buy the building itself. An estimate of the present value of the city's rental and residual payments might be $3 million. The lessor can afford to set rental payments below the purchase price of the building because of the tax benefits he receives from deductions for accelerated depreciation and interest expense. The value to the lessor of these tax benefits could easily amount to $1.5 million. Of these tax benefits, $1 million would go towards the purchase price of the city hall building, and $0.5 million would be left over to cover the lessor's profit and administrative costs. Although there is no line item in the Federal budget, the city government has nevertheless been able to pay for one-quarter of its new city hall with federal tax dollars. This could be viewed as off-budget revenue sharing, and it may be a less efficient way to aid State and local governments than ordinary revenue sharing because some of the Federal cost is absorbed by middlemen involved in structuring the lease.

Congress already provides assistance through the tax system by means of the exclusion, from federal tax, of interest paid on municipal bonds. The 1982 combined cost to the U.S. Treasury of the ex-

clusion of interest on State and local housing, pollution control, hospital, industrial development, and general purpose bonds was over $10 billion. Leasing increases the amount of assistance that State and local governments receive through the tax system. In some instances, State and local governments combine the benefits of leasing and tax-exempt debt in the same transaction (tax-exempt leverage lease financing). Because the magnitude of these leasing tax benefits is unknown, it is difficult for Congress to evaluate this type of assistance. Unlike housing or hospital bonds, for example, the use of leasing benefits is not restricted to any particular purpose. Furthermore, for both municipal bonds and leasing arrangements, Congress relies on intermediaries to pass through tax benefits to State and local governments. A sizable portion of the revenue loss to the Treasury may be drained away by these intermediaries instead of being passed through to State and local governments. Therefore, in an efficiency sense, on-budget revenue sharing is more efficient than assistance through the tax system.

D. Tax-Exempt Organizations

As in the case of State and local governments, there is no aggregate information available on the level of leasing activity by tax-exempt organizations. Thus, there is no way to estimate the revenue loss to the Treasury as a result of these types of leases. In the case of leasing by unrelated businesses owned by tax-exempt organizations, the law treats the income of these businesses as taxable. The policy issues here are the same as for corporate leasing generally, since the tax treatment is the same. However, for leased property used in a related activity, the question of eligibility arises: did Congress intend that tax-exempt organizations should receive tax benefits from leased property which they would not be eligible for if they purchased the property? Furthermore, because these tax benefits do not appear in the unified federal budget, it is difficult for Congress to determine the amount of tax revenue given up as a result of nonprofit leasing.

E. Possible Directions for Change

Leasing raises important issues of eligibility, efficiency, and accountability at all levels of government. Federal departments, state and local governments, and tax-exempt organizations can obtain tax benefits through leasing which would otherwise be denied to them. These tax benefits come directly out of Treasury's receipts and increase the federal deficit. In addition, there is reason to suspect that a significant portion of the benefit is drained away by middlemen instead of benefiting the nontaxables. Thus, compared to on-budget outlays, assistance through the tax system may be inefficient. Last, because the revenue loss to the Treasury does not appear in the budget, and is not broken down by agency or function, it is hard for Congress to evaluate the costs of leasing.

Under current law, the investment credit is denied on property used by units of government and tax-exempt organizations unless use of the property is obtained by means of a service contract. One possible change would be to deny the investment credit to property used by units of government that is obtained by a long-term lease,

whether or not the contract is structured as a service or a capital lease. Generally, this would have the effect of denying the investment credit to nonprofit entities where tax benefits are an important motivation for the lease.

A corollary change would be to deny some of the benefit from ACRS depreciation to property used by units of government and tax-exempt organizations where use is obtained by means of a long-term lease, whether or not the contract is structured as a service or a capital lease.

Another direction for reform would be to increase accountability for long-term lease transactions. In the case of federal departments, this might be achieved by a requirement that the authorized amount for cumulative lease payments appear in the procurement section of the department's budget rather than in the O&M account. Second, federal departments might be required to compute the cost to the Treasury of their long-term leasing proposals for the use by the congressional authorizations and appropriations committees.

For State and local governments as well as tax-exempt organizations, accountability could be improved by including the Treasury cost of their long-term leasing agreements in the tax expenditure budget prepared annually by the OMB, the JCT staff, and the Congressional Budget Office.

APPENDIX: ACCOUNTING FOR GOVERNMENT LEASES

The purpose of this Appendix is to describe the method of accounting for government leases used in part IV. This economic accounting framework measures both the outlay and revenue costs of leasing and adjusts for the fact that outlays in future years are less burdensome than current outlays.[1] This provides a more accurate indication of the costs to the government of multi-year procurement programs than does the unified federal budget. The staff believes that the economic accounts permit a more meaningful comparison of the real costs to the government of leasing versus buying.

Economic accounts can be calculated on a pre-tax or an after-tax basis. The pre-tax method discounts before-tax outlays at a before-tax discount rate, while the after-tax method discounts after-tax outlays at an after-tax discount rate. Although both methods yield similar results, the pre-tax method is easier to implement since tax reflows to the Treasury need not be measured. The pre-tax accounting system is explained in the first part of this section. Some analysts have claimed that while leasing appears unfavorable to the government from a pre-tax point of view, the after-tax accounting method shows leasing to be advantageous. To address this issue, an after-tax accounting methodology is described in the second section of this Appendix. The staff's conclusion is that both methods of accounting show leasing to be more expensive to the government than buying.

A. Pre-tax Accounting Method

For capital budgeting purposes, OMB directs government agencies to measure the real resource cost of multi-year outlay programs using the pre-tax method. All future outlays obligated by and incidental to a procurement program are discounted at a specified pre-tax rate. OMB chooses a discount rate which reflects the pre-tax cost of funds: the prevailing interest rate on government bonds. The pre-tax cost of funds is larger than the after-tax cost by the amount of taxes paid on the interest income received by the owners of government bonds. Since this tax reflow to the Treasury is already included in the pre-tax discount rate, it would be double-counting for government agencies to adjust their outlays by the estimated reflows. The Argent study's conclusion ("TAKX Maritime Prepositioning Ships, Relative Financing Costs of Charter and Purchase, Supplemental Report"), that leasing is less expensive than buying TAKX ships, appears to be a result of their inappropriate double-counting of tax reflows.

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[1] It is assumed that whether or not the government leases, it intends to control deployment throughout the useful life of the property.

On a pre-tax basis, the cost to a government agency of buying an asset is just the purchase price. If the agency leases, the cost which should appear on the agency's budget is the present value of all payments to the lessor pursuant to the leasing agreement. These payments include rents and the cost of buying the property from the lessor at the end of the lease (the residual). From the Treasury's perspective, there is no revenue impact if the agency buys the asset since the normal reflow attributable to the tax on interest paid to government bondholders is accounted for in the pre-tax discount rate set by OMB. However, if the agency enters into a leveraged lease, there is a reduction in Treasury receipts due to the net tax benefits available to the lessor. The lessor's overall tax liability decreases as a result of the lease because the investment credit and the deductions for accelerated depreciation and interest expense exceed the income attributable to rental and residual payments. Since government agencies cannot claim the investment credit or accelerated depreciation, there is no comparable revenue loss to the Treasury if the agency buys rather than leases from a taxable intermediary. Clearly, leasing is an arrangment which allows tax benefits to be passed through to entities which are not eligible for them on their own account, such as federal government departments, State and local governments, and non-profit institutions.

The total government cost of procurement is the present value of the outlays which appear on the agency's budget plus the present value of the revenue loss to the Treasury. This revenue loss does not, of course, appear under the agency's outlay budget but is reflected in reduced tax revenues and, hence, a larger budget deficit. The agency, Treasury, and total government cost of procurement is shown in Table 1. For lease financing, the total government cost of procurement equals the present value of rent and residual payments (on the agency budget), plus the present value of tax benefits to the lessor (on the Treasury account). If, instead, the agency buys, the total government cost of procurement just equals the purchase price on the agency account (since there is no Treasury impact). Thus, from a total government perspective, the additional procurement cost due to lease financing is the difference between the total government cost of leasing (agency plus Treasury cost) and the purchase price.

TABLE 1.—PRE-TAX ECONOMIC ACCOUNTS: LEASE VERSUS BUY

[All amounts in present value and discounted at a pre-tax rate]

Agency finance method	Agency cost	Treasury cost	Total Government cost
Lease	Rent +Residual	Tax benefits	Rent +Residual +Tax benefits.
Buy	Purchase price.		Purchase price.

TABLE 1.—PRE-TAX ECONOMIC ACCOUNTS: LEASE VERSUS BUY—Continued

[All amounts in present value and discounted at a pre-tax rate]

Agency finance method	Agency cost	Treasury cost	Total Government cost
Lease minus buy.	Rent ..... +Residual..... −Purchase price.	Tax benefits	Rent +Residual +Tax benefits −Purchase price.

B. After-Tax Accounting Method

Some advocates of government leasing have claimed that the pre-tax accounting method is unfair to leasing since certain tax reflows to the Treasury are ignored. In particular, it is argued that the tax paid on the interest received by the holders of the lessor's debt reduces the revenue loss to the Treasury. To evaluate this type of argument, it is necessary to calculate the economic accounts in after-tax dollars. Since outlays are reported net of tax reflows in the after-tax method, future year amounts should be discounted at the government's after-tax cost of funds. The after-tax discount rate is just the pre-tax cost of funds specified by OMB minus the portion of costs recovered through the tax reflow on bondholders' interest income. Notice that it is inappropriate to discount after-tax outlays at OMB's pre-tax cost of funds since this effectively double-counts tax reflows.

If in 1985 the Department of Defense (DOD) intends to purchase a ship, and other spending is not cut, then either tax revenues must be increased or the Federal debt will rise to cover the ship's cost. Therefore, the government's cost of financing is the general revenue devoted to the project plus the present value of principal and interest payments on the government's bond issues used to finance the project. However, if the DOD hires a lessor to finance the ship, the Department's cost is just the present value of rent and residual payments.

Accounting for tax reflows, Treasury's revenues increase when the government buys a ship because of the taxes paid by the recipients of interest on government bonds. Thus, the cost of buying a ship is negative on the Treasury's account. In the case of a lease, Treasury's revenues are reduced by the tax benefits in the lease, and revenues are increased by the reflow from: (1) taxes paid by the lessor's creditors, and (2) taxes paid on the fee income earned by the attorneys and other middlemen who structure the lease.

The total government cost of procurement is the present value of the agency's outlays plus the Treasury's revenue loss, discounted at the after-tax rate. The agency, Treasury, and total government cost of procurement are shown in Table 2. In the after-tax accounting framework, the total government cost of leasing is the present

value of the agency's payments to the lessor plus the Treasury's net revenue loss after reflows. If the agency buys, the total government cost is the financing expense (general revenue and debt service) minus reflows to the Treasury from the taxes paid by government bondholders. The difference between the total government cost of leasing and buying, as shown in Table 2, depends on the relative financing costs of the government and the lessor (after reflows), and the tax benefits in the lease.

TABLE 2.—AFTER-TAX ECONOMIC ACCOUNTS: LEASE VERSUS BUY

[All amounts in present value and discounted at an after-tax rate]

Agency finance method	Agency cost	Treasury cost	Total Government cost
Lease	Rent +Residual	Tax benefits −Creditor's tax. −Middlemen's tax.	Rent. +Residual. +Tax benefits. +Creditor's tax. −Middleman's tax.
Buy	General revenue. +Interest +Principal	−Bondholder's tax.	General revenue. +Interest. +Principal. −Bondholder's tax.
Lease minus buy.	Rent +Residual −General revenue. −Interest −Principal	Tax benefits −Creditor's tax. −Attorney's tax. +Bondholders' tax.	Rent. +Residual. +Tax benefits. −Creditor's tax. −Attorney's tax. −General revenue. −Interest. −Principal. +Bondholder's tax.

C. Pre-tax Economic Analysis of Lease Versus Buy Decision

The pre-tax and after-tax accounting methods described above can be used to compare the total government cost of leasing and buying. In this section it is shown that the additional costs of leasing can be allocated to three sources: (1) the lessor's profit, (2) the difference between the lessor's and the government's cost of financing, and (3) the legal and administrative fees associated with the lease. The staff concludes that long-term leasing cannot be cheaper than buying unless the lessor has such a large financing cost advantage over the government that it offsets his profits and fees.

The measurement of leasing costs starts with the definition of the lessor's net economic income (profit). Profit equals rent plus residual income, less the sum of taxes, interest, principal, and fee payments and the equity insertion

$$\begin{aligned}\text{PROFIT} = {} & \text{RENT} + \text{RESIDUAL} - \text{TAXES} \\ & - \text{INTEREST} - \text{PRINCIPAL} - \text{FEES} \\ & - \text{EQUITY}.\end{aligned}$$

The lessor's tax benefit is the reduction in his tax liability as a result of the lease (i.e., the negative of taxes paid)

$$\text{TAX BENEFITS} = -(\text{TAXES PAID}).$$

The agency's cost of leasing is the present value of rent and residual payments made to the lessor

$$\text{AGENCY COST} = \text{RENT} + \text{RESIDUAL}.$$

The lessor's pre-tax financing cost consists of equity, debt service, and fees

$$\text{LESSOR FINC COST} = \text{EQUITY} + \text{INTEREST} + \text{PRINCIPAL} + \text{FEE}.$$

Using these definitions, the lessor's profit can be written as the sum of tax benefits and agency costs minus the lessor's financing cost

$$\begin{aligned}\text{PROFIT} = {} & \text{TAX BENEFIT} + \text{AGENCY COST} \\ & - \text{LESSOR FINC COST},\end{aligned}$$

where all amounts are in present value.

On a pre-tax basis, the excess procurement cost due to lease financing is the difference between the total government cost of leasing (agency cost plus tax benefits) and the direct purchase price (see Table 1). Therefore, the pre-tax excess cost of leasing is given by

$$\begin{aligned}\text{PRE-TAX EXCESS COST} = {} & \text{AGENCY COST} \\ & + \text{TAX BENEFIT} - \text{PRICE}.\end{aligned}$$

Using the formula for the lessor's profit derived above, it can be seen that the pre-tax excess cost of leasing is equal to the lessor's profit and financing cost minus the purchase price

$$\begin{aligned}\text{PRE-TAX EXCESS COST} = {} & \text{PROFIT} + \text{LESSOR FINC COST} \\ & - \text{PRICE}.\end{aligned}$$

Therefore, leasing imposes an excess cost to the extent that the government must pay for the lessor's profit and excess financing costs.

The lessor's financing cost can be analyzed by exploiting the "bond interest rule." [2] The bond interest rule states that the pres-

[2] The bond interest rule holds for all debt instruments, such as government bonds, on which: (1) interest is paid on the unpaid principal, and (2) cumulative principal payments sum to the loan amount.

ent value (PV) of principal payments equals the loan amount minus the product of the present value of interest payments and the ratio of the discount rate (g) to the interest rate (i)

$$\text{PV PRINCIPAL} = \text{LOAN} - \left(\frac{g}{i} \times \text{PV INTEREST}\right)$$

Using the bond interest rule, the lessor's financing cost can be rewritten as the sum of the project's equity and loan amounts, plus the cost due to the difference between the lessor's pre-tax borrowing rate (i) and the government's pre-tax cost of funds (g)

$$\text{LESSOR FINC COST} = \text{EQUITY} + \text{LOAN} + \left(i - \frac{i-g}{i} \times \text{PV INTEREST}\right) + \text{FEE}.$$

The difference between the lessor's and the government's borrowing rates (i−g) is attributable to the market's perception that the lessor has a greater risk of default than the government. Accordingly, the last term in the lessor's financing cost equation can be thought of as the risk premium on the lessor's debt. Since the equity and loan financed portions of the project sum to the full purchase price, the expression for the lessor's financing cost can be simplified to yield

$$\text{LESSOR FINC COST} = \text{PRICE} + \text{RISK PREMIUM} + \text{FEE}.$$

This shows that the lessor's financing cost can be broken down into three components: the price of the project, the risk premium on the lessor's debt, and the fees paid to third parties to structure the lease.

From the preceding expression for the lessor's financing cost it may be seen that the pre-tax excess cost to the government of leasing is equal to the sum of the lessor's profit, risk premium, and fees.

$$\text{PRE-TAX EXCESS COST} = \text{PROFIT} + \text{RISK PREMIUM} + \text{FEE}.$$

In conclusion, even if the lessor and the government have exactly the same cost of funds, there can be no gain to the government from leasing if the lessor earns a profit or there are legal and other fees associated with the transaction. Normally the lessor's cost of funds exceeds the government's by a risk premium which is passed on to the government in the form of higher rents. That is, the government pays an excess cost to lease whenever it contracts with a lessor whose borrowing rate is larger than its own.

D. After-tax Economic Analysis of Lease Versus Buy Decision

On an after-tax basis, the excess cost attributable to lease financing is net of tax reflows arising from taxes paid by the lessor's creditors and lawyers, if the government leases, and from the government's bondholders, if the government purchases. By definition, the difference in reflows between leasing and buying is given by

$$\text{REFLOW} = \text{CREDITOR'S TAX} + \text{ATTORNEY'S TAX} - \text{BONDHOLDERS' TAX}.$$

Notice that the leasing reflows (creditor's and middleman's tax) are offset, more or less, by the reflows that arise if the government purchases (the tax paid by the government's bondholders).

The government's financing cost is the sum of the general revenues devoted to the project plus the present value of interest and principal payments discounted at the after-tax cost of funds

$$\text{GOVT FINC COST} = \text{GENERAL REVENUE} + \text{INTEREST} + \text{PRINCIPAL}.$$

Using these definitions, the after-tax excess cost of lease financing (see Table 2) may be written as

$$\text{AFTAX EXCESS COST} = \text{AGENCY COST} + \text{TAX BENEFIT} - \text{REFLOW} - \text{GOVT FINC COST}.$$

From an after-tax perspective, the excess cost of leasing is equal to the difference between the total government cost of leasing (agency cost plus Treasury cost minus net reflow) and the cost to the government of self-financing. From the definition of the lessor's profit the after-tax excess cost of leasing can be re-expressed as

$$\text{AFTAX EXCESS COST} = \text{PROFIT} + \text{LESSOR FINC COST} - \text{GOVT FINC COST} - \text{REFLOW}.$$

Therefore, leasing imposes an excess cost to the extent that the government must pay for the lessor's profit and excess financing costs (after reflow).

The lessor's and government's financing costs can be analyzed by means of the bond interest rule. The appropriate rate for discounting outlays net of tax reflows is an after-tax rate. From the government's perspective, the after-tax cost of funds (r) is the pre-tax rate on government bonds (g) times (1-m), where m is the marginal tax rate on interest income

$$r = (1 - m)\, g.$$

Using the bond interest rule it can be seen that the government's cost of financing may be re-expressed as

$$\text{GOVT FINC COST} = \text{GEN REVENUE} + \text{LOAN} + \left(\frac{g - r}{g} \times \text{PV INTEREST}\right).$$

The last term in the government's financing cost equation is equal to the taxes paid by government bondholders: that is, the tax rate on interest income (m) times the present value of interest payments on the government's bonds. Since the general revenue and loan financed portions of the project sum to the purchase price, the

expression for the government's financing cost may be simplified to yield

$$\text{GOVT FINC COST} = \text{PRICE} + \text{BONDHOLDERS' TAX}.$$

Lessor's financing cost, at an after-tax discount rate, can also be determined from the bond interest rule

$$\text{LESSOR FINC COST} = \text{EQUITY} + \text{LOAN} + \text{FEE} + \left(\frac{i-r}{i} \times \text{PV INTEREST}\right).$$

The last term of the expression for lessor's financing cost can be rewritten as follows:

$$\left(\frac{i-r}{i} \times \text{PV INTEREST}\right) = (1-m) \times \left(\frac{i-g}{i} \times \text{PV INTEREST}\right) + (m \times \text{PV INTEREST}).$$

This can be interpreted as the sum of the after-tax risk premium on the lessor's debt and the taxes paid on the interest income received by the lessor's creditors. Since the equity and loan financed portions of the project sum to the purchase price, the expression for the lessor's financing cost may be simplified to yield

$$\text{LESSOR FINC COST} = \text{PRICE} + (1-m) \times \text{RISK PREMIUM} + \text{FEES}.$$

This shows that the lessor's financing cost can be broken down into three components: the price of the project, the after-tax risk premium on the lessor's debt, and the fees paid to structure the lease.

From this analysis of the government's and lessor's financing costs, it may be seen that the after-tax excess cost to the government of leasing is equal to the sum of the lessor's profit, after-tax risk premium, and after-tax fees.

$$\text{AFTAX EXCESS COST} = \text{PROFIT} + \text{AFTAX RISK PREMIUM} + \text{AFTAX FEES}.$$

In conclusion, even if the lessor can borrow at the same rate as the government, there can be no gain to the government from long-term leasing if the lessor earns a profit or there are middleman's fees associated with the transaction. Since lessors normally borrow at a higher rate than the government, and pass these costs through as higher rents, it generally will be less expensive if the government does its own financing rather than relying on a lessor.

E. Summary

Both the pre-tax and after-tax economic accounting methods indicate that the cost to the government of leasing exceeds that of buying. This conclusion is a result of the fact that leasing involves excess costs which would not have to be borne if the government

bought. Regardless of the accounting method adopted, these excess costs are attibutable to three sources: (1) the profit absorbed by the lessor, (2) the generally higher borrowing cost of the lessor (i.e., the risk premium on the lessor's debt), and (3) the legal and administrative expenses associated with a lease that are avoidable if the government buys. These results are unchanged when credit is given for reflows to the Treasury resulting from the taxes paid by the lessor's creditors and middlemen.

Chairman RANGEL. The next witness is from the General Accounting Office, Werner Grosshans, the Deputy Director for Procurement, Logistics, and Readiness Division.

We thank you for your participation. Would you please identify those people that will be with you.

STATEMENT OF WERNER GROSSHANS, DEPUTY DIRECTOR, PROCUREMENT, LOGISTICS, AND READINESS DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY GERALD GODSHAW, ECONOMIST, PROGRAM ANALYSIS DIVISION; PAUL EDMONDSON, ATTORNEY-ADVISER, OFFICE OF GENERAL COUNSEL; AND JOHN RINKO, GROUP DIRECTOR, PROCUREMENT, LOGISTICS, AND READINESS DIVISION

Mr. GROSSHANS. Before I begin my prepared remarks, I would like to introduce the people with me here at the table. To my left is John Rinko, group director; Paul Edmondson, attorney-adviser; and to his right is Dr. Gerald Godshaw, economist.

I am pleased to have this opportunity to appear before this subcommittee to discuss the General Accounting Office's prior work on the Navy's program to lease rather than purchase nine tankers.

Recent proposals by the Navy and the Air Force to lease rather than purchase Government equipment have prompted several Members of Congress to ask us for a detailed review of the issues involved in such leasing arrangements. Although our study has just begun, it will cover economic and budget effects, the magnitude of such leasing arrangements, and their impact on wartime mobilization. Our work should be completed by May 1, 1983.

While the results of our current work are not complete for these hearings, we believe the issues surrounding today's leases are similar to those we reported on earlier.

Our August 15, 1973, report entitled, "Build and Charter Program for Nine Tanker Ships"—B-174839—covered the Navy's build-and-charter program and its unusual financing method, which committed the Government to significant expenditures of funds—fixed charter payments—in future years.

By renting instead of purchasing, the Navy applied operations and maintenance—O&M—funds over a long period of time, thereby avoiding the type of congressional scrutiny that large procurement outlays would involve.

In June 1972, the Military Sealift Command, Department of the Navy, entered into the build-and-charter program for nine new tankers. Private interests provided for the construction and financing, and the Navy agreed to lease the tankers, with renewal provisions for up to 20 years.

We recognize that leasing is one means of acquiring the use of equipment. However, the magnitude of the funds involved in the nine-tanker transaction clearly warranted congressional input to the decisionmaking process. At that time, Navy officials agreed that the manner in which Congress was informed of the program could be improved.

To improve congressional visibility of future build-and-charter programs, we recommended that the Secretary of Defense assist

the Congress by: Providing information on the proposed method of acquisition—long-term leasing or purchasing; providing appropriate congressional committees a detailed cost analysis showing full impact on future budgets when long-term leasing is the proposed acquisition method; and requiring analyses of long-term leasing arrangements to be made on a total-cost-to-the-Government basis, including the direct effects of delayed payments of income taxes.

Ten years ago, Navy officials stated that their preference for leasing stemmed from their inability to obtain procurement funds. The requests were denied at higher levels within the Navy or the Department of Defense because procurement funds were needed for higher priority combatant ship construction programs. The build-and-charter program was designed to meet the Navy's need for new tankers without spending procurement funds.

The nine tankers are operated under the Navy industrial fund, a revolving fund reimbursed from appropriated O&M funds from the Army, Navy, Air Force, and Marine Corps. Industrial fund operations allow the Navy to spread costs to the other military services.

The oil and gasoline transportation rates are set annually on the basis of forecasted costs, and the military customers are billed at those rates for services received. Thus, the cost of operating the tanker fleet—including charter costs—are ultimately passed on through the Navy industrial fund to the O&M accounts of the military services receiving the transported oil and gasoline products.

The 1972 build-and-charter program involved nine ships valued at a total cost of $160 million. In comparison, the current TAKX maritime pre-positioning ship contracts involve 13 ships valued at a total of $2.39 billion. In addition, in 1972, the build-and-charter program received only the informal review of selected committee staff members. The current program has received written approval of the House and Senate Committees on Armed Services and Appropriations.

While there are some differences between the program in 1972 and the current programs, we do believe that many of the issues raised then are equally important today. These include: The extent of congressional oversight of long-term leasing arrangements; the cost elements to be used in computing the total cost to the Government; the discount rate to be used in preparing a present value analysis of the arrangement; and the procedures to be used in such comparisons.

Concerning the issue of congressional oversight, we recognize that there is, in the current fiscal year 1983 defense funding authorization, a notification requirement for these types of ship-leasing transactions. In our previous audit report, however, we recommended that the Congress consider a permanent statutory provision similar to that requiring congressional approval of any proposal to lease a public building at an annual rental in excess of $500,000.

On the issue of the cost elements and the discount rates to be used, we believe the total cost to the Government must be an important consideration.

The total costs include not only the lease payment by the agency involved—in this case the Navy—but also the relevant tax revenue consequences to the Treasury of leasing as opposed to purchasing.

Such tax consequences are indeed numerous, complex, and occur at different points in time throughout the lease period. Any future costs or revenues must be discounted to current dollars so that the purchase cost can be compared to the total costs of leasing in current dollar terms.

The cost comparison of leasing as opposed to purchasing is then sensitive not only to the magnitude of the cost components, but also to the interest rate used to discount future costs. Our current work will attempt to deal more with these issues.

Because these leasing arrangements have set a precedent, it may be appropriate for the Department of Defense and the Office of Management and Budget to determine the guidelines that will be used to make these long-term lease-versus-purchase analyses. A clear set of guidelines would also aid Congress in its oversight responsibilities.

This concludes my statement, Mr. Chairman, and I would be happy to respond to any questions you may have.

Chairman RANGEL. Mr. Pickle?

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Grosshans, based on your report of the 1972 build-and-charter program, and your review of this particular case, the TAKX case, are there, prior to the Navy's release for a request for proposal, any formal mechanisms for the legislative input or oversight with respect to these long-term leasings?

Mr. GROSSHANS. As a general proposition, the answer is no.

There was a specific requirement in the 1983 Authorization Act.

Mr. PICKLE. Not before then?

Mr. GROSSHANS. That is correct. The language was very specific and dealt only with Navy leases after fiscal year 1982.

Mr. PICKLE. Is it correct that the Navy issued these RFP's before consultation with Congress? Is that correct?

Mr. GROSSHANS. To my knowledge, that is correct, sir.

Mr. PICKLE. Then the Navy first went public by the issuance of the RFP's, and then came to Congress and said, what do you think about that, once it was well on the way towards accomplishment?

In a sense, the actual consultation was an accessory after the fact.

Mr. GROSSHANS. I think that is basically correct, Congressman.

Could I elaborate on that, sir, in all fairness to the Navy? I think Congress probably was better advised as to what these consequences might be, by having some firm figures on hand based on the RFP results.

Mr. PICKLE. I think I would agree somewhat. Congress is very restricted in their oversight. Once the process gets underway and the RFP's are issued, we then try to play catchup; and your testimony says we ought to have guidelines so that could be prevented.

Otherwise, once you start it, it is hard to know what to do.

I remember Representative Daniels said, "Congressional review boils down to a combination of after-the-fact gratifications and Hobson choices." That is rather blunt, but that may be the fact of it.

Let me ask you this question.

In its ruling of January 28, 1983, GAO stated that the Navy may not, through acceptance of vessel delivery, agree to commencement

of the lease arrangement if the obligational availability of the Navy's fund—that is, their industrial fund—is at the time insufficient to cover any consequential increase in the Government obligations.

Now, does this mean that the Navy must, upon delivery of the vessels, have enough money in the NIF—Navy Industrial Fund—to cover the termination costs of canceling the contract?

Mr. GROSSHANS. Yes, Mr. Pickle, it is the termination costs as well as the firm lease charter for the period. It is the first 5 years' lease cost, plus the termination charges; so it is a combination of those two that should be obligated in the NIF.

Mr. PICKLE. Then the Navy must have enough money in that NIF to cover any termination costs?

Mr. GROSSHANS. Yes, sir.

Mr. PICKLE. Given the money involved, how can it be cheaper for the Navy to lease, if it is required to have this kind of cash on hand?

What sum of money are you talking about?

Mr. GROSSHANS. I am advised it is roughly about a $3 billion impact up-front.

Mr. PICKLE. How could it be cheaper for the Navy to have that much cash on hand? Suppose this lease was terminated, and the IRS ruled against them, that means they have to keep $3 billion on hand. How can that be cheaper just to cover the possibility of a ruling from the IRS?

Mr. GROSSHANS. There are two different aspects to this. One aspect is total obligational authority that would have to be set up up front. Now, whether the actual amount of money that would have to be in a fund at a particular time, this is the outlay side, would have to equal that. That would depend on what the cash flow would be in the NIF at the time. It may not be the exact amount.

Mr. PICKLE. Let's assume that it was somewhere in the neighborhood, of what you said, where would the Navy get this money?

Mr. GROSSHANS. They would have to come back to get additional obligational authority.

Mr. PICKLE. They would have to come back and get additional obligational authority, or they would have to ask that the law be changed?

Mr. GROSSHANS. That is correct, sir.

Mr. PICKLE. Of the two, they probably would ask the latter, wouldn't they?

Mr. GROSSHANS. I don't know.

Mr. PICKLE. Well, now, did the Navy have knowledge of this requirement prior to consummating the lease?

Mr. GROSSHANS. The Navy worked with our General Counsel in this particular case, and I guess the question was not resolved until very recently as to how much would actually have to be set up. I guess it was the hope of the Navy that only the lease payment would have to be obligated, since it is assumed to be a going concern, and, therefore, it is not very likely that all of the ships would be terminated during this particular period.

Mr. PICKLE. That was not my question. My question was: Did the Navy have knowledge of this kind of responsibility in case a termination came about?

Mr. GROSSHANS. If I understand your question correctly, would it have had knowledge of the termination charges? It would have.

Did they have knowledge as to what the total amount would have to be, and what would have to be capitalized? I don't think they assumed the total amount would have to be set up up-front. They assumed that they would have enough in the NIF to cover the leases.

Mr. PICKLE. Wouldn't they have to also assume that if a termination came about, that they would have to come up with an awful lot of money?

Mr. GROSSHANS. That is right.

Mr. PICKLE. One other question, sir.

Mr. GROSSHANS. The way the Navy proposed to do that, I think they would have preferred to treat the termination charges or potential termination costs as a footnote to the financial statement.

Mr. PICKLE. Yes, and that may be the proper word, and yet, since we don't have the rulings, it may be much more than just potential. You have to say, well, what are the obligations?

On November 22, 1982, the GAO wrote to Senator Stevens of the Senate Appropriations Committee and said that the Air Force lacked authority under current law to enter into a multiyear lease to replace the aging CT-39 aircraft. To your knowledge, has that situation changed as a result of legislation later in 1982?

Mr. GROSSHANS. No, sir. The situation is the same. The cases are different between the Navy and the Air Force. In the Navy case, the reason they could go ahead with use of the O&M funds, which are 1-year funds, and make these types of lease arrangements is because they had the opportunity to work it through the working capital fund.

In the Air Force case, that is not the situation, and, therefore, the Air Force readily admits they would have to have special legislation to be able to do the same thing.

Mr. PICKLE. Doesn't it follow that if the Air Force lacked authority to enter into a long-term lease with respect to these C-39's, doesn't it follow that maybe the Navy would have the same problem? Is there that much difference between the two agencies?

Mr. GROSSHANS. I don't think there is a difference between the agencies, but there is a difference in the way we have looked at it from the standpoint of the legality, because in one case it is a direct O&M transaction and in the other case the O&M funds flow through the industrial fund, and, therefore, there is no prohibition as far as we can find to prevent the industrial fund from being used for these types of transactions.

Mr. PICKLE. One last thing: You said that your study—you will do a study on this whole subject?

Mr. GROSSHANS. Yes, sir.

Mr. PICKLE. Will you have it completed by May? Can't you get that study completed quicker?

The budget will be advanced by that time, and we need to have this information faster than May. Can you produce it earlier?

Mr. GROSSHANS. We will try, and we can certainly come up and brief the staff on the tentative results on those studies underway now.

Chairman RANGEL. Mr. Dorgan?

Mr. DORGAN. Ostensibly, the Navy would have looked at the information provided the Navy by the consultant that they paid, and the consultant told the Navy that the argument that tax revenue losses should be accounted as part of the cost of the charter program is questionable. Then they set out two grounds, and one of which few of us in this room could understand, and the other one is that it assumes these tax revenue losses would not occur in the absence of the charter program.

Your 1972 GAO study took the opposite position, as I understand it. Your analysis was that the Navy analysis of the charter payments did not reflect the total cost to the Government, because it did not take into account the direct tax benefits of this type of transaction.

Had you been advising the Navy instead of this consultant, would you have taken the same position that you did in 1972, that the revenue losses to Government need to be considered and need to be counted as part of the costs of the charter program?

Mr. GROSSHANS. I think our position would be the same as we had in 1972. Basically, we feel that the total cost to the Government needs to be considered in these transactions. I think, as was mentioned by previous witnesses, that one can come up with a completely different result if one looks at only agency costs versus total Government costs, and I think that was basically our position in 1972 and remains today. We need to take a look at the total consequences and then make the decision.

Mr. DORGAN. Is there any reasonable basis on which someone could take the other position?

The consultant has done it but made a mockery of good sense.

The cost to the Government is only the cost of the lease, and you ignore the cost of the tax loss, and that is, in effect, what the consultant advises the Navy?

Mr. GROSSHANS. I don't see how one can argue that, because those are real costs and would have to be considered in the tradeoff analysis that is made here.

Mr. DORGAN. Well, I appreciate your testimony.

Chairman RANGEL. Mr. Pease?

Mr. PEASE. I thank you very much, Mr. Chairman.

Mr. Grosshans, I want to pursue a point Mr. Pickle raised before about the NIF fund and termination costs.

It is the GAO's position, I gather, that the NIF fund would have to be sufficient to cover the total conceivable obligations of the Federal Government before commencement of the contract. Is that correct?

Mr. GROSSHANS. Not total conceivable. I think what we have stated is total lease payments for the 5-year period, plus the identified costs of potential termination, were termination to occur during this particular period. That is the total amount that would have to be obligated.

Mr. PEASE. Does the Navy disagree with that interpretation?

Mr. GROSSHANS. I don't believe so. I think we have pretty well ironed that out. I will defer to Navy later, but I am not aware of any difference of opinion at this point.

Their initial argument was that it should only be the 5-year charter costs and not the termination costs, but based on a ruling that we issued, I am not aware that there is still a debate on that.

Mr. PEASE. Termination costs could be very substantial.

Mr. GROSSHANS. Yes, sir.

Mr. PEASE. This contract for the [illegible] ships was signed last year, and subsequently the Navy has signed another contract for the 5 tankers. Do I assume from that that the NIF fund, the obligational authority, is sufficient to cover those termination costs in both cases?

Mr. GROSSHANS. It is not. There is not enough money right now in there to reflect those total potential costs of both the 5-year leases and the termination charges, and the Navy would probably have to do one of two things. They would either have to get additional authority or get a waiver through legislation.

Mr. PEASE. And at what point does the fund, the obligational authority, have to be sufficient; at the time the contract is commenced, or during the period of the contract, while construction is underway, or what?

Mr. GROSSHANS. I will defer to Paul.

Mr. EDMONDSON. Once they accept delivery of all the vessels. During the 2-year construction/conversion period, the Navy can limit its liability to a certain amount and the maximum amount of that is somewhere in the range of $2 billion, which they have right now in the industrial fund, as we understand it.

Mr. PEASE. I see. At least I think I see.

At the commencement of the contract, your position, which as far as you know the Navy agrees with, is that there would have to be sufficient obligational authority available, but it would not be the full amount, because the Navy is not fully responsible until the ships are completed?

Mr. EDMONDSON. Because they can limit their firm obligation; that is correct.

Mr. PEASE. Is the obligational authority, does that have to apply specifically to these ships, or could it be obligational authority unused for a *Nimitz* class aircraft carrier, for example?

Mr. GROSSHANS. In total, it would have to cover all firm obligations. But the point you are getting at is where some of the obligational authority, in essence, comes from. The Navy's argument would go along the lines that if they had to absorb these costs, they would defer overhauls, for example, on some of the ships, and thereby be able to cover the eventual costs of termination.

Any unobligated balance within the NIF may be used to cover the obligations created by the TAKX contracts, even though not specifically designated for that purpose. However, the Navy may not rely on its ability at some future time to defer presently scheduled overhauls to cover present TAKX obligations.

Mr. PEASE. So that this provision is not really much protection to the people, whether there is enough obligational authority or enough cash in the case of outlays relates to independent factors from this particular leasing project. Is that right?

Mr. GROSSHANS. I would agree with that, yes.

Mr. PEASE. If there happened to be obligational authority there for a *Nimitz* aircraft carrier and construction has been slow and there is a $2½ billion left over, even at the time of delivery of the ships, that that obligational authority could be used to cover the leasing of the ships, at least on a temporary basis?

Mr. GROSSHANS. I think I agree with what you have stated.

It is my understanding that as long as the total of firm obligations are recognized, and the fund has sufficient assets available to cover those—not just for these particular ships—the money for TAKX could come from cancellations of other activities that the Fund is there for. Then generally we would feel the Fund would be intact. The worst that could happen is that, in order to cover up-front TAKX obligations you would have some deferrals on maintenance or other NIF activities.

Funds deobligated from deferrals of other NIF activities could indeed be used to cover the up-front TAKX obligations. Deferrals, however, would not occur in aircraft carrier construction, as this is not an NIF activity, but instead might occur in such areas as ship overhauls. The cancellation of other NIF activities in order to create sufficient obligational authority for the TAKX program would only be "temporary" to the extent that such activities may be resumed once additional resources become available for obligation.

Mr. PEASE. Thank you very much, Mr. Chairman.

Chairman RANGEL. Is it safe to say, in summary, that under the existing law, that there is no way for the Congress to know what the total costs will be under these leasing arrangements for any procurements by the Navy or any other Federal Department if it intended to lease instead of purchase?

Mr. GROSSHANS. You mean under current procedures?

Chairman RANGEL. Under current procedures.

Mr. GROSSHANS. I think that is a correct statement.

Chairman RANGEL. Thank you for your cooperation.

I join with Mr. Pickle's request to get us an outline of what you have, and you can supplement it until your report is concluded, but in order for it to have any benefit at all to us, we would like for it to be done before the Budget Committee reaches its conclusions.

[The following was subsequently received:]

GENERAL OUTLINE OF ISSUES TO BE ADDRESSED IN GAO's REVIEW OF FEDERAL LEASING PRACTICES

The issues that GAO plans to address in its review of Federal leasing practices, in general, and the TAKX program, in specific, fall into three major categories: (1) financial, (2) programmatic, and (3) legal.

The following outline lists the particular issues and sub-issues GAO plans to review under each of the three major categories.

A. FINANCIAL

1. Analysis of Coopers and Lybrand and Argent economic analyses and comparison of these studies with studies prepared by the Joint Taxation committee and GAO.

2. Description of factors that should be included in a lease v. purchase evaluation in order to determine total cost to the Government.

3. Monetary impact if IRS rules against ITC and ACRS.

4. Budget implications resulting from long term leasing programs such as the TAKX.

B. PROGRAMMATIC

1. To the extent possible, we plan to identify the magnitude of long term leasing in DOD.
2. Reasons why DOD would perfer to lease rather than acquire certain types of capital equipment such as the TAKX ships.
a. May not be able to obtain procurement funds.
b. Need to retain industrial base mobilization capability.
c. Reduced budget outlays in the early years.
d. In DOD's view, leasing is less costly than procurement.
3. The effect of long term leasing on the Congressional authorization, appropriation and oversight process.
4. Impact on mobilization capability by using contractors to perform key military functions/services.
a. Use of contractor support is increasing.
b. Not unique to ship leasing or long term leasing programs.
c. Can contractor personnel be required to perform key military functions/services in hostile or wartime situations?
d. What are the alternatives if they refuse?

C. LEGAL

1. Legislative and administrative actions needed to insure that when long term lease arrangements are proposed, that these arrangements are, in fact, the best alternative.
2. May need new legislation which provides for routine notification to and approval by key Congressional Committees.
3. Contrast and comparison of statutory requirements that apply to procurement but not long term leasing arrangements.

Mr. GROSSHANS. We will try to be back up with your staff and brief them on our tentative conclusions.

[Subsequent to the hearing, the subcommittee submitted questions to the GAO. The questions and answers follow:]

GAO'S RESPONSE TO QUESTIONS POSED BY THE HOUSE WAYS AND MEANS COMMITTEE

Question 1. In 1973, GAO concluded that the 1972 Navy tanker leasing arrangement was in fact more costly to the Government than if a direct purchase had been made. Is that correct? If so why?

GAO response. Whether or not leasing is more economical than purchasing depends on the discount rate used to calculate the present value of future payments. The GAO policy is to discount at a rate equal to the yield on Government securities maturing at the same time the project ends. Thus, the discount rate for a 5-year project is the average yield to maturity of all outstanding Government securities that mature in 5 years. At the time of our 1973 report, the average yield was about 6 percent. Using a discount rate of 6 percent, the decision to purchase would have been more economical by $29.6 million.

Question 2. In the 1973 GAO review, exactly what factors did GAO determine must be considered in assessing the total cost to the Government?

GAO response. The factors we considered were the direct tax effects of the transaction. We adjusted the charter payments to reflect a deferral of taxes in the early years of the transaction. We made this adjustment because the tax effects were a significant factor in the transaction. The tax effects were tax on lease payments and any interest income to the lessor, and tax deductions for depreciation, interest expense, and other expenses.

Question 3. Should the same factors GAO considered in 1973 be considered in any similar lease-versus-purchase cost analysis made today?

GAO response. We believe that the same factors we considered in 1973 should be considered today. Furthermore, any changs in tax laws or depreciation schedules that have taken place since 1973 must be considered. In summary, we believe the total cost to the Government must be considered and not merely the Navy's rental payments. Further, the investment tax credit (for qualified assets) must be considered along with any recapture required associated with current depreciation laws. Our current work will examine all these factors.

Question 4. How important are the tax benefits available to the lessors in these leasing arrangements and specifically what are they?

GAO response. The tax effects are very significant factors in these leasing arrangements. Specifically, they include the investment tax credit and an accelerated depreciation arrangement along with the interest paid deduction. Without these tax effects the charter payments by the Navy will be higher. That is the reason the Navy has agreed to cover any adverse tax rulings that may be handed down by the Internal Revenue Service.

Question 5. What major policy considerations should be addressed by this tax-writing Committee, and by the Congress as a whole, in evaluating the cost of leasing rather than purchasing major Government assets.

GAO response. In our view, the major policy consideration is whether it is appropriate for any governmental agency to finance its operations through tax leasing arrangements. That is, the tax expenditures do not come from that agency's budget. Instead, part of the cost of the equipment is passed on to the Treasury in the form of reduced revenues.

Another important issue is the budgetary treatment of such long-term lease arrangements. Although these long term commitments require the up-front recording of obligations, they are financed through the use of working capital funds, and therefore, do not receive the same scrutiny that more traditional financing methods involve.

Question 6. In GAO's work so far in reviewing Navy leasing practices, have you found a standardized, clearly recognizable and understandable set of Government-wide guidelines that require departments to conduct a detailed lease-versus-purchase cost analysis and which set forth those items which must be included in such an analysis?

GAO response. Such analytical guidelines for lease vs. purchase currently do not exist. Although the Office of Management and Budget may be best suited to formulate guidelines, any such guidelines would vary from case to case. We do not believe that any standard framework should include the total cost to the Government which includes the relevent tax consequences. Our on-going work will further address this issue.

Question 7. Should these leasing arrangements—whether made by Navy, the Air Force, or another Government agency—receive close Congressional scrutiny? If so, why?

GAO response. We believe that these leasing arrangements deserve greater Congressional scrutiny. Long-term leasing arrangements are often financed through the unobligated balances of working capital funds, reimbursed by the operations and maintenance (O&M) accounts of customer agencies throughout the life of each lease. The lease arrangements will appear in O&M budgets of the customer agencies as services are performed, and consequently will receive congressional review through the authorization and appropriations process at those times. This review, however, is really after-the-fact. At the time the actual obligations are created, Congressional oversight is limited to that required by section 303 of the fiscal year 1983 Defense Authorization Act. Although the Antideficiency Act requires the obligations to be covered "up front," the funds with which they are covered (i.e., the unobligated balances of working capital funds) are not included in the annual authorization and appropriations process.

Question 8. In 1973, GAO recommended permanent legislation requiring prior Congressional approval of long-term lease proposals. Do you still believe such legislation is needed? If so, please describe the provisions that should be considered. If not, why not?

GAO response. In our 1973 report, we recommended that the Congress consider permanent legislation providing for Congressional approval of long-term leasing of such assets as ships. We suggested that legislaton similar to that requiring committee approval of building leases over $500,000 a year might be appropriate. We still believe that such legislation is needed, and we are currently in the process of drafting language for Congressional oversight provision. This suggested language will be included in our up-coming audit report. It will contain a requirement that agencies, when seeking arrangements, transmit a lease vs. purchase comparative cost analysis with any such proposal.

Question 9. On February 25, 1983, the Joint Committee on Taxation released a staff pamphlet entitled "Tax Aspects of Federal Leasing Arrangements". The Pamphlet sets forth an economic and accounting methodology to determine total costs to the Government of leasing versus-purchasing.

(a) Is this methodology consistent with the GAO's views?

(b) If not, what methodology does GAO recommend should be used by the Government in such lease versus-purchase decision?

GAO response. The methodology the Joint Committee on Taxation used in their February 25, 1983, pamphlet set forth an economic and accounting methodology consistent with the views of GAO. We believe the total costs, which include the appropriately defined tax costs, should be considered in a lease vs. purchase analysis. Although we may not believe the use of OMB's 10 percent discount rate as the most appropriate, the general framework of the Joint Committee's analysis appears most appropriate. We also cannot guarantee that any analysis we do in the area would result in exactly the identical numerical result. Differences could arise due to different economic and financial assumptions. However, we feel their general approach, in terms of identifying and quantifying the important factors, would be consistent with one we would take.

Chairman RANGEL. Thank you very much.

The next panel will include Department of Defense, William A. Long, Deputy Under Secretary for Acquisition Management; Department of the Navy, Everett Pyatt, Principal Deputy Assistant Secretary, Shipbuilding and Logistics; and Department of the Air Force, Lloyd K. Mosemann, Deputy Assistant Secretary for Logistics and Communications.

Mr. Long will start off and then the Navy and the Air Force, and of course, Mr. Long, you could read your testimony or respond to some of the questions raised or proceed as you would like.

STATEMENT OF WILLIAM A. LONG, DEPUTY UNDER SECRETARY FOR ACQUISITION MANAGEMENT, DEPARTMENT OF DEFENSE

Mr. LONG. We appreciate the opportunity to come here and discuss with you the Department of Defense leasing procedures generally, as well as the specific programs that you have identified in your various letters.

Let me introduce today the Navy and Air Force representatives that are with me. On my left is Mr. Lloyd Mosemann, the Deputy Assistant Secretary of the Air Force for Logistics and Communications, and on my right is Mr. Everett Pyatt, who is the Principal Deputy Assistant Secretary of the Navy for Shipbuilding and Logistics.

I have submitted a written statement for the record which I assume, Mr. Chairman, will be inserted and I won't take the time of the committee to simply read what you already have.

What I would rather do is take a moment and emphasize a few points that I think really ought to be emphasized and then I would ask for the opportunity for Mr. Mosemann and Mr. Pyatt to present their summaries of their statements as well.

Chairman RANGEL. We will follow your recommendations and your full testimony without objection will appear in the record at this point.

Mr. LONG. Thank you.

There seems to be, based on some of the testimony earlier today, an undercurrent of perhaps a question that we do an awful lot of leasing within the Department of Defense.

We have underway the preparation of some data that we will have to provide you for the record to indicate what leasing is, as a portion of the total procurement account, O&M account, and the total DOD budget.

Leasing really is a very small part of our overall acquisition program. We really, when we acquire by contract, have three avail-

able mechanisms. We can purchase, lease or we can aquire contractor services.

I think it is constructive to put into the proper frame of reference the size of the activity in which we in the Department are engaged.

During any recent average years, 1980, 1981, 1982, 1983, the Department of Defense enters into about 12½ to 13 million contract actions per year.

That doesn't mean contracts. That can include contract modifications, conversions from letter contracts to definitive contracts; about 12½ to 12 million events requiring pieces of paper.

We have something in the neighborhod of 300,000 contracts in excess of $25,000 in 1981 and 1982. The vast majority of those contracts, involve the utilization of hardware purchase contracts. We do lease Automatic Data Processing Equipment, or APDE, photocopy machines and a variety of others, and I shouldn't say that; those are service contracts, I believe. We acquire the services of photocopy equipment by service contracts but if one did a total count of dollars, you would see really that the leasing and the service contracting where hardware is involved are really not very much of our budget.

That is not to say, however, that your inquiry and the inquiry of our oversight committees into the contracts that you have mentioned here today is not something that ought to be undertaken. We have no hesitancy at all to share with you the basis for our decisionmaking and we would certainly work with you and any other committee to work out the appropriate guidelines and methodologies but I do want to put it in perspective.

I think it is also within that frame of reference that the size of the acquisition activities which we engage in, and it is also fair to say that in the department or in the Office of the Secretary of Defense, we really encourage our contracting activities to try new things.

Multiyear pocurement is one that we have engaged in as a result of working with the Congress over the last couple of years because we think it is the smart thing to do. Going back to prior administrations, you can see other instances of other innovative ways of acquiring the services we need, some have worked and some haven't.

As is indicated here today, the concept of service contract and leases has been used in the past. There are perhaps some new wrinkles, new nuances to some of the activities that are currently in process or being considered, and we encourage that.

If they work, fine, we will do them again, and if they don't work, we will not do them again.

We try to encourage innovative acquisition approaches, and in my view, one could say, why did you grant the deviations from the Defense Acquisition Regulation [DAR]? To facilitate the contract that the Navy entered into and I will tell you quite frankly, I did it because I thought the approach was innovative and they did a good job in their analysis, and it was clear that there had to be some one-time deviations to go through with the negotiations.

I wouldn't sit here and tell you that I was certain this would work and would be a new methodology that would be the be-all and

the cure-all, but it was a good technique that I thought was thoughtfully presented to me by the Navy and I gave them my full support and I would do it again if those criteria are met.

I will also add that in terms of this as an approach, just as other approaches that we are trying to foster, we analyze them on a case by case basis.

I had said earlier that the vast majority of the equipment that we acquire, either directly or by the use of service contracts, we acquire by purchase.

Most of what we acquire is militarily unique. Somebody mentioned earlier the leasing of missiles. Quite frankly, that is absolutely silly. One can come out with a parade of horrors on almost anything new. Someone else mentioned that it is customary to lease automobiles or copying machines. Well, somebody did that on the first time, so custom on the one hand and the parade of horribles on the other really doesn't add to the thoughtful analysis that this kind of transaction really requires.

It detracts from what we really ought to be focusing on, the transactions on a case-by-case basis.

To the extent that there has been innuendo, and there has been here this morning, that the Department of Defense or one of the DOD components is trying to slip one by the Congress, that is absolutely not the case. Several of you gentleman have acknowledged yes, we did go to the oversight committees.

The RFP says what we are asking the oversight committee to approve and it was well in advance before any contract had been entered into and it would not have been entered into but for the approval of the oversight committees. Until that RFP goes out, there is not a clearly instructive action which we could present.

It is not fair to say we are really trying to slip one in or make up for a shortfall in the procurement account.

Mr. PICKLE. That just isn't the case.

This committee hasn't said that.

Mr. LONG. I stipulate that.

At this table there has been some innuendo to that effect today.

Mr. PICKLE. A lot of questions have to be asked in connection with it.

Mr. LONG. Fair enough.

On the matter of review process which is something I know you want to get into in more detail in your questions, we do have a review process for transactions of this and other types within the Department that includes a development of the rationale, first of all, the acquisition strategy, and then the rationale within the military department that is the sponsor or the command that will issue the procurement.

In the case of the ships it is the Navy, and in the case of certain trainer aircraft, if that were to materialize into an RFP that would be issued, that would be the Air Force.

Before such an RFP is effective or issued and any action is taken on it, the Office of the Secretary of Defense, what is conventionally known as OSD, does get involved with the services, and from an economic analysis standpoint and I hasten to add, it is an economic analysis standpoint that considers the cost to the Government, not just cost to the Department of Defense or the military component.

The Office of Program Analysis and Evaluation is involved and was involved in this case. Our office, as indicated earlier, was involved because in order to effect the transaction as structured, we had to grant certain waivers from the Defense Acquisition Regulation clauses of various types.

I will not pretend to tell you that I or my office or my staff engaged in an economic analysis that would have been duplicative of the analysis of the Office of Program Analysis and Evaluation. I am generally familiar with the fact that they did an analysis, that, while the methodology perhaps was slightly different than the Navy, it supported the Navy analysis at least in the proposition that either a purchase or the method put into place were very, very close, at least close enough that in my judgment, let's try it.

In this instance, where both analyses were generally supportive of the proposition that this is something we ought to try.

There are other nonfinancial considerations that go into this analysis again on a case-by-case basis.

That is probably—I have taken more time than I really intended to emphasize the points that I felt were worth emphasizing. If it is agreeable with you, I will have Mr. Pyatt of the Navy give whatever comments he would feel appropriate, followed by Mr. Mosemann of the Air Force.

[The prepared statement follows:]

STATEMENT OF WILLIAM A. LONG, DEPUTY UNDER SECRETARY OF DEFENSE (RESEARCH AND ENGINEERING) ACQUISITION MANAGEMENT

Mr. Chairman, members of the committee, I am William Long, Deputy Under Secretary of Defense (Research and Engineering) for Acquisition Management.

We appreciate the Opportunity to discuss with you leasing policies and practices in the department of defense and specifically, the questions posed by the subcommittee on oversight in the letters from Chairman Rangle of 14 February 1983. With me today are Mr. Everett Pyatt, Principal Deputy Assistant Secretary of the Navy for Shipbuilding and Logistics, and Mr. Lloyd Mosemann, Deputy Assistant Secretary of the Air Force (Research, Development and Logistics) for Logistics and Communications.

With your permission, I will open the testimony with a discussion of DOD's general policies and practices regarding leasing and Mr. Pyatt and Mr. Mosemann will then discuss the specific cases of the TAKX ships and replacements for the CT-39 aircraft which were the subject of the subcommittees questions.

Let me say at the outset that the tax impact and the time value of money are taken into consideration in the tradeoff analyses of lease versus by decisions. It should also be noted that the lease of assets for use by the department has traditionally been a small fraction of the total DOD budget. Regardless of recent reports in the press that may leave a contrary impression, we do not expect this basic fact to change. The reasons why leasing will not expand significantly are many:

There is no new or altered DOD policy to employ leasing arrangements in preference to purchase contracts for the acquisition of hardware. Most of our requirements do not lend themselves to leasing because they are for unique military hardware for which there is no commercial equivalent. Military hardware usually has specific performance characteristics peculiar to the military application and would require extensive modification to commercial equipment. Often, these items are expendables which are used in training or combat. Lastly, there are existing legislative restrictions. Where leasing can be reasonably employed, the practice is not new. Examples of where leases have been used in the past include real property, automatic data processing and office equipment, charters of transport equipment, and the Civil Reserve Air Fleet (CRAF).

Presently, goods and services needed by the Department of Defense to carry out its mission can be acquired by purchase or by lease. Under either alternative, we can either operate and maintan the items ourselves (utilizing government personnel) or buy the services to do so. In addition, we may acquire services from the private sector that involve the incidental use of real and personal property (the Gov-

ernment neither buys nor leases the property in these cases). One or another of these forms of acquisition, or combinations thereof, have been used throughout the history of this country.

DOD acquisition practices recognize that there are some situations in which the Government's equipment requirements may be more economically filled by rental rather than by purchase. The decision whether to lease or purchase has to be arrived at on a case-by-case basis because of the variety of products, market conditions, and other circumstances involved. There are many considerations that must be taken into account. By way of illustration, I will mention the following: Duration of the requirement, nature of the hardware, state of the art, commercial availability or equivalent, use of all or only a portion of an entity such as a building, how and where the hardware will be used, availability of in-house resources to operate and maintain equipment, willingness of industry to participate, and legislative guidance, authority or constraints.

To determine whether purchase would be costlier than rental, we use cost analysis techniques we have developed or acquired over the years in the Military Departments and in the Office of the Secretary of Defense. We are prepared to discuss with you the results of analyses in specific cases and why we believe that a particular decision to lease rather than to buy is reasonable. As I indicated earlier, tax impacts are considered in such analyses.

On the question of the Department's internal review procedures, I believe it would be best if we addressed these in the specific examples we will discuss to illustrate the steps and the participants involved. In general, I would like to point out that acquisition reviews by the Office of the Secretary of Defense are conducted primarily on the basis of the dollar value of the transaction and not whether the acquisition will be accomplished by lease or by purchase.

DOD, like other Departments and Agencies of the Federal Government, is bound by the Government's general policy that (1) the Government will rely on the private sector for goods and services; (2) that certain functions are inherently governmental in nature and must be performed by Government personnel, and (3) relative cost must be given appropriate consideration in decisions between in-house performance and reliance on private commercial sources. Leasing can also be, in selected circumstances, consistent with our policy to use commercial products to the maximum extent rather than products developed uniquely for military use.

Chairman RANGEL. Well, Mr. Secretary, I don't think anyone on this committee disagrees with anything that you have said.

Did I miss any economic analysis as to whether or not this lease agreement would be more costly to the American taxpayers than a direct purchase?

Mr. LONG. What I said, Mr. Chairman, is that within the Office of the Secretary of Defense, an economic analysis, including factoring tax consequences, in other words, a cost to the Government, was conducted by the Office of Program Analysis and Evaluation.

Chairman RANGEL. What was their result?

Mr. LONG. Their result was that it was close enough to a wash, based upon certain assumptions which are predictions that the transaction ought to go forward in the manner that the Navy had structured.

Chairman RANGEL. Is it safe to say you used this tax leasing procedure because the money was denied under the appropriation process for this same type of ship operation?

Mr. LONG. I am not certain I understand your question, Mr. Chairman.

Chairman RANGEL. Well, obviously, you didn't have the money for the purchase because the Congress denied it. Is that correct?

Mr. LONG. It may have in prior years. This went forward in the year in question as a transaction along the lines that the Navy had structured.

Chairman RANGEL. I understand that the appropriations to purchase 13 ships was requested and denied by the Congress. Is that correct?

Mr. LONG. I don't think so, Mr. Chairman. I don't think it was requested.

Mr. PYATT. I will get to that. In one prior year they were denied by the Congress with a direction to the Navy to investigate chartering as part of the program to rely on the Merchant Marine for services at this time.

Chairman RANGEL. Please speak up.

Mr. PYATT. In one prior year, the appropriations for the first ship were denied and the instructions that were in the committee report were to look into chartering as well as acquisition of these ships.

Chairman RANGEL. You never had money appropriated for the purchase. Is that correct?

Mr. PYATT. No, sir.

Chairman RANGEL. You didn't have the money for purchase, and you are saying that if you did have it, as far as the overall costs to the taxpayer, it would be the same as if you leased it?

Mr. LONG. Roughly the same based upon assumptions of future interest rates, which either could have lowered the lease cost or raised it, but it was close enough based upon our analysis that in fact we didn't go back and ask for appropriations for procurement dollars, we went forward on the lease program.

Chairman RANGEL. It would not be violative of anything in national security for us to have before this committee the factors that you considered as relates to costs, so that we could share this with——

Mr. LONG. I will be happy to provide that for the record. I can't tell you exactly how our analysis within the Department of Defense, Navy or OSD relates to, is consistent with or perhaps inconsistent with the testimony of witnesses prior, because we only received that report Saturday.

[The information follows:]

COST FACTORS CONSIDERED IN ANALYSIS OF LEASING

The specific form of the cost analysis depends on the particular financial structure of an acquisition. An analysis of a transaction involving leasing would typically include outflows due to accelerated depreciation and investment tax credits as well as inflows and outflows due to tax liabilities created or eliminated by the leasing contract. A government discount rate of 10 percent and a marginal tax rate of 46 percent are assumed for those analyses.—OSD.

Chairman RANGEL. As relates to costs, Mr. Secretary, did you share whatever you used to reach a decision with the Treasury Department in reaching a conclusion as to what the ultimate costs would be to the taxpayer?

Mr. LONG. I don't believe we engaged in a dialog with the Treasury at that time but if that is not the case, I will clarify that for the record.

Chairman RANGEL. Were the considerations before you discussed with the Office of Management and Budget before a decision was made to lease?

Mr. LONG. Before the ultimate decision was made, yes, they were, and I would have to provide the details of those discussions for the record.

Chairman RANGEL. OK. So that I make it abundantly clear, we are not being critical of the Navy using laws which the committee has already approved for the most part. But, of course, we sometimes don't know how these laws are being used and sometimes abused. Normally we deal with the private sector in this. So to the extent that you can, we would like to know what interagency, interdepartmental, executive branch of Government exchanges were made. It is clear that if a budget is presented to us by the executive branch and one is a tax expenditure and the other is an appropriation expenditure, and there has been no discussion, then I don't see what committee would have oversight of this except the tax committee. We oversight too often after the fact. There would be no congressional oversight if you made these decisions on your own without being in a position to tell us that the costs are already included in the budget that has been presented to us by the administration.

Mr. LONG. I understand, and to the extent that the Congress feels additional oversight by additional committees is germane and relevant on a particular issue, that is a decision for Congress to make.

I do think that we in the Department, both the Navy, Air Force and OSD, acted in accordance with our understanding of what was expected of us by our oversight committees.

I will provide you the extent to which we interrelated with the other departments—well, I will provide further information.

[The information follows:]

EXTENT OF DIALOG WITH OTHER DEPARTMENTS

It is our understanding that the Treasury Department does not involve itself in individual decisions made by other Departments. Moreover, the Internal Revenue Service does not render advance opinions on tax questions involving known taxpayers. However, DoD has consulted with Treasury on matters of economic analysis pertaining to lease versus buy decisions.—OSD.

Chairman RANGEL. I assume the Department of Navy and Defense were not operating at arm's length with Department of Treasury?

Mr. LONG. It isn't a question of operating at arm's length, Mr. Chairman. I don't know there was a dialog on this particular issue.

Chairman RANGEL. Then, how could you possibly determine it was less costly to the Government to lease? Who would you be talking with, if not the Treasury Department?

It is a matter of analytical methodology. Who would you talk to to determine what the tax expenditure would be as opposed to a direct purchase?

Mr. LONG. There have been several methodologies discussed here today and it doesn't take members of the Treasury to determine the tax effects of a particular transaction.

Chairman RANGEL. I am not arguing with you, Mr. Secretary. I am asking you to share your analytical methodology with me.

Mr. LONG. I told you, of course, we will. I can't tell you what we did with the Treasury in the past is my point.

Chairman RANGEL. Well, I thought I had made it clear in my letter of February 14 that that was one of the reasons why we asked you to testify at this hearing. So that we would know just how you made your good faith assumptions as relates to cost. When we say costs, we are talking about tax expenditures, as well as direct appropriation costs, and I thought you would know that.

Mr. LONG. I apologize, Mr. Chairman, but we are working on developing all of the information. We just don't have it all yet and we will provide it for the record.

[The information follows:]

ASSUMPTIONS REGARDING COST TAX EXPENDITURES

Where an acquisition involves the leasing of equipment for long periods of time, the measure of tax impact used by DoD is discounted net cash flow: the present value of all additional tax revenues and tax expenditures which would result from leasing, as compared to direct purchase.—OSD.

Mr. PICKLE. Mr. Chairman, I have a couple of questions to ask the Secretary and I would like to proceed, but are you going to give us time to interrogate the Secretary or do you want to go on to the other testimony?

Chairman RANGEL. We will proceed at whatever is your pleasure.

Mr. PICKLE. I want to nail down one thing, if I can. Can you give this committee an estimate of the total costs of the Navy's preposition maritime project, over the long-term contract? Capital hire, personnel costs, fuel, et cetera. What is the 25-year cost on this? The sum of $2.3 billion? If you leased it, what would it cost approximately on a 25-year basis?

Mr. LONG. Sir.

Mr. PYATT. On a 25-year basis, we have been operating on the per ship present value differential and the test that we have shown is that we believe there is $28 million per ship less expense, less expense to the Government per ship.

That is over a 25-year basis.

Mr. PICKLE. What I am driving at is, if we purchase it, it cost $2.3 billion; but if we enter into this lease arrangement over the period of time that you have, and the Joint Tax Committee says it is a 25-year lease, would it cost $4 billion, $5 billion, $6 billion? Surely you ought to have some kind of a roundhouse figure?

Mr. PYATT. We make a statement in our representations to our committees and as we went through the review process of the cost of the——

Mr. PICKLE. We will get your testimony in 1 minute.

Mr. Secretary, before I leave you, you said that an economic analysis is routinely done on a project like leasing, and the total cost to the Government is always considered. That was your testimony, sir?

Mr. LONG. I don't know that I used routine, because these are not routine transactions but on these transactions——

Mr. PICKLE. You said, "Let me say at the outset that the tax impact and the time value are taken into consideration" and so on.

Mr. LONG. Oh, right.

Mr. PICKLE. Was such an analysis done with respect to the CT-39's? Can this committee be informed, do you use tax impact with respect to the CT-39's?

Mr. LONG. I don't know that the Office of the Secretary has done that yet.

Mr. PICKLE. You did not use tax impact with respect to those CT-39's and yet you said that you have. Maybe there is a misunderstanding.

Did the DOD consult Treasury prior to the decision to lease regarding the tax consequences of the tax proposition?

Mr. LONG. My office did not. I am in the process of determining whether the Office of Program Analysis and Evaluation or any other office did.

Mr. PICKLE. I have a memorandum from one of your personnel which says that quote, "No investor involved in a formal, long term over 6-month lease with a Government organization is eligible for the 10-percent investment tax credit."

The clear inference from that is your people are saying you are not eligible to do it.

There was considerable question in your mind about whether you should proceed or not.

Mr. Chairman, I have some other questions but we ought not to hold up the testimony.

Chairman RANGEL. OK. Any direct questions for the Secretary before we move on to the Navy and the Air Force?

Mr. Dorgan.

Mr. DORGAN. I notice in your testimony that you state that the tax impact and the time value of money are taken into consideration, leases versus purchase.

You were here during the previous testimony, and I assume you have taken a look at the consulting study done by the consultant that I referred to this morning in earlier questioning. In all of those cases, there seems to be uniform agreement that the decision that was made by the Defense Department on these prepositioning ships ended up in a situation which will cost the taxpayers about 12 percent more than if the Defense Department had purchased those ships outright? Do you disagree with that conclusion?

Mr. LONG. I am not prepared to say that the 12 percent is or is not the right number.

I am certain, it is the number that flows from the methodology used.

We have not had an opportunity to examine the methodology used in the Joint Taxation Committee report. We just received that report this Saturday. Reasonable people can differ on methodologies and I agree with the comments from the witness stand, as well as the subcommittee members, that there should be a methodology developed and we would be most pleased to participate with the Joint Tax Committee, OMB, GAO, and with this committee in developing one.

Mr. DORGAN. In your testimony, you say that the methodology of taking into consideration the tax impact is one that you support. I am saying that the Joint Tax Committee points out that if you consider that, the taxpayer ends up paying 12 percent more for the prepositioning ships.

Mr. LONG. Simply to say that I support the notion that the tax effects should be included in the analysis is not to say that there cannot also be differing methodologies on how the taxes are to be

considered in the report and I just don't know how they did it compared to how PA&E did it. Their analysis would have had a much closer than 12 percent relationship.

Mr. DORGAN. If the analysis of the tax loss experienced by the Government, plus the lease costs, concludes that the Government will pay 12 percent more for those prepositioning ships than if the Government purchases them outright, somebody has made a $250 million mistake, do you agree?

Mr. LONG. I would agree that the $250 million would need to be justified on other grounds, and there are, as others have stated or will state later today, there are other considerations.

One is the support of the merchant marine, things like the fact, or the prospect at least that money may be cheaper in the future than it is today, so the interest rate assumptions that one uses may not turn out to be the case, so there are other factors than just tax aspects.

Mr. DORGAN. I understand that you would look for support in other areas if, in fact, it turns out that this approach costs the taxpayer 12 percent more than outright purchase, but it seems to me that those that were involved in purchase decisions or lease decisions, Department of Defense, should want to use the principle of least cost for comparable quality.

What I am saying, if the analysis is accurate, is that somebody has made a mistake worth almost a quarter of a million dollars. Who makes the ultimate judgment when we go ahead with this lease agreement in the DOD?

Mr. LONG. The process requires that the decision ultimately be made, made or ratified, by the Secretary of Defense and the Defense Resources Board.

The process begins with a DOD component or a subordinate command, in this case the Navy, works up through the Navy, and through the Office of the Secretary of Defense.

Mr. DORGAN. The testimony earlier today pointed to the lease arrangement appearing in the O&M budget rather than the procurement budget. That's one reason the Navy prefers to lease. But the ultimate decision involves over $2 billion in which we are talking about a potential cost overrun of 12 percent, or at least an increase in costs beyond what we should pay if it was purchased. Is that decision made ultimately by the Secretary, Deputy Secretary, Under Secretary?

Mr. PYATT. The Deputy Secretary of Defense made the decision to proceed with the program in December.

Mr. DORGAN. It was his judgment we would get those ships cheaper by lease.

Mr. PYATT. That it was likely to be a wash.

Mr. DORGAN. It was the Secretary s judgment that it would not necessarily be cheaper for the Federal Government to purchase than to lease?

Mr. PYATT. The representations that we made at that time, and one of the issues we do need to get into, is the lack of any rationale for making these assessments that exist at that time and this is one of the points in the joint committee report.

How do you go about making the analysis and what assumptions do you use?

[The following additional information was received:]

TAX METHODOLOGY

Amplifying information for the record. This appropriate methodology takes into account all tax inflows and outflows to the Treasury and therefore, must be on an after-tax basis. While the Argent Group felt that a 10 percent discount rate was a proper after-tax discount rate under the economic conditions in August 1982, they included a range of discount rates from 5 percent to 14 percent in the report, due to the lack of a consensus on the calculation of discount rates. The 10 percent discount rate also coincided with OMB's Circular A-76. This methodology indicated that, under the then current interest rates, chartering was about 15 percent or $28.6 million per ship less expensive than purchase for a total program savings in excess of $370 million assuming a cash purchase.

The Joint Tax Committee, on the other hand, assumed that if the Government purchased the ships, it would not be for cash but rather financed by having the Treasury sell bonds for 100 percent of the purchase price. The Joint Tax Committee then compared a deficit financed purchase with our charter costs on a pre-tax basis. This methodology avoids consideration of substantial tax inflows to the Treasury under the charter while still considering the entire amount of tax outflows. Apparently, the Joint Tax Committee did not understand that the Argent report was done on an after-tax basis and assumed a purchase for cash which is why the Joint Tax Committee erroneously thought that the Argent report double-counted certain tax inflows. It is noted that the Joint Tax Committee acknowledged that it would be proper to use an after-tax analysis but then asserted that the result would be no different between a pre-tax and an after-tax analysis without providing any supporting calculations.

We do not believe it is valid to assume that a Government purchase would, in fact, be 100 percent deficit financed. Nor is it accurate to use a methodology such as that employed by the Joint Tax Committee, which does not consider the tax inflows as well as the total outflows from leasing.

One could argue that Argent should not have assumed a 100 percent cash purchase in view of the projected Federal deficits of approximately 20 percent in Fiscal Years 84 and 85. If it is assumed that a Government purchase would be 80 percent cash and 20 percent deficit financed, then an after-tax analysis, using a 10 percent discount rate, results in chartering being $14 million less expensive than a purchase.

For these reasons, we believe that the report which the Navy provided to the Oversight Committees last August, is more appropriate than that recently prepared by the Joint Tax Committee.

Mr. DORGAN. I would guess that those who made the decisions might well be uncomfortable by the analysis made by the joint Tax Committee, and others for whom I have great respect. We may well have made a rather expensive error in the DOD. I have a brochure that describes the Navy sealift programs. If I might ask the Secretary, the language in this brochure talks about sealift supply for the rapid deployment force, and the force must be able to counter and deter aggressive acts, which could occur at any time and these ships will be stationed at forward bases to provide immediate support. This suggests that these ships would in some respects be in harm's way at some point, ships that the Government does not own, with crews that the Government does not control.

Do you really want to put a leased ship with a nonmilitary crew in areas as you described them in this brochure?

Mr. LONG. The first point is to remind you, these are noncombatant ships.

Mr. DORGAN. I understand.

Mr. LONG. The brochure that you held up there is not one with which I have any recollection. I may have seen it but I don't recall it.

The Navy can address the tactical use of these ships better than I, but my understanding is that they are not ships that are going to be in what I will call a war zone.

Mr. DORGAN. All right.

Chairman RANGEL. Mr. Pease, any questions of the Secretary?

Mr. PEASE. Mr. Chairman, I will be glad to wait until the others have testified.

Chairman RANGEL. Mr. Pickle.

Mr. PICKLE. Mr. Long, the committee has decided to go on through the lunch hour. I don't want to hold you, Mr. Secretary. Are you able to stay with us through this or would you like us to ask any questions of you so you can be excused?

Mr. LONG. I am prepared to stay for a while at least.

Mr. PICKLE. Let me ask a couple of questions because he may leave.

Mr. LONG. I will give you time.

Mr. PICKLE. I won't impose on Mr. Pease.

STATEMENT OF EVERETT PYATT, PRINCIPAL DEPUTY ASSISTANT SECRETARY, SHIPBUILDING AND LOGISTICS, DEPARTMENT OF THE NAVY

Mr. PYATT. First I would like to clarify that the Navy is not leasing ships but we are buying services, merchant marine services of the same kind that are now being employed by 17 ships at Diego Garcia.

Chairman RANGEL. Please speak more directly into the microphone.

Mr. PYATT. I would like to reiterate that the ships that are being considered here this morning are not military ships, not combatant ships but the same kind of ship, with the same mission as the ships that are currently being employed at Diego Garcia—17 ships manned by merchant mariners, not by Navy—so some of the issues that have been raised this morning about the propriety to rely on the merchant marine are ill-founded.

Mr. PICKLE. We know you classify these as noncombatant ships. Yet they are in a war zone, are of considerable size, and they have been referred to by the GAO as military equipment.

You have already designated that this was a very critical area of the world with possibly volatile developments; so this is more than just a bareboat vessel, a different type of vessel.

Mr. PYATT. They are performing a similar mission to that now being performed.

Mr. PICKLE. Do the 17 ships at Diego Garcia get the investment tax credit?

Mr. PYATT. I am not familiar. Some have been subsidized by the Maritime Administration.

[Additional information follows:]

INVESTMENT TAX CREDIT

Mr. PICKLE. Do the 17 ships at Diego Garcia get the investment tax credit?

Mr. PYATT. The seventeen ships stationed at Diego Garcia as part of the NTPF include one Sealift Class tanker which has been bareboat chartered to MSC since it was built in 1974. Since a bareboat charter is a direct lease to the Government the Investment Tax Credit (ITC) was not available. Two other tankers at Diego Garcia were orginally chartered to MSC in 1971 and 1972 under consecutive voyage

charters as a result of a build and charter program. The owners obtained an IRS ruling that the ITC was available for those ships. There are also two RO/RO's built in 1976 and 1977 for private charters and eligible for the ITC. Upon their bareboat charter to MSC in 1980 they were subject to a recapture of a portion of the ITC.

One other RO/RO was built in Germany in 1977 and purchased for time charter to MSC in 1980 by a U.S. steamship company so it would not have been eligible for the ITC. The remaining eleven ships were built in U.S. shipyards for U.S. owners and not bareboat chartered to the U.S. Government so they should have been eligible for the ITC with the possible exception of one which was built in 1961 and may pre-date eligibility for the ITC. Since the youngest of these 11 ships was built in 1975 and the oldest 1961 with many in the mid 1960's, and not chartered originally to MSC, we do not know whether or not the owners actually receive the ITC. All of the 17 ships would have been eligible for depreciation deductions under the then applicable schedules.—Navy.

Mr. PICKLE. There is an abundance of these kinds of ships and they may not get it but it raises a question.

The proposition that we have before us, is it economical, is it a wise policy to make this purchase——

Mr. PYATT. I am only trying to place this in the context of the other things that are going on presently.

I would like to submit my statement for the record and emphasize a few points that I think are important.

Chairman RANGEL. Without objection.

Mr. PYATT. First, one of the issues that has come up this morning is the issue of what risk the contractor accepts. Basically a contractor has to furnish a ship that is ready to operate or it does not get paid, and we don't get in the middle of preparing a ship for operation or doing anything like that. It is not a Navy ship.

Failure to do this results in lost revenue. All of the controllable risks within the provision of services are the contractor's responsibility and the financing risks are split or accepted by the Navy to allow costs to be reduced by falling interest rates.

One of the problems we had in doing the analysis was that interest rates were rapidly falling. We couldn't predict exactly how they were going to happen. We didn't want to be in a situation of being tied to high, long-term rates when financing was finally placed.

The structure of this particular service procurement is very similar to commercial ship service agreements except that the Navy has had to accept fewer risks than one would normally see in a commercial ship contract.

I recognize the purpose of the hearing is to review tax impacts of Government leasing and chartering programs but from my perspective, a business agreement cannot be judged by tax impact alone. Many other aspects have to be considered in a charter/buy decision. I will briefly summarize some of the things that we felt at the time we were thinking about this particular alternative, thinking about how we should go about best acquiring the services for fulfilling this mission.

These fall in three basic categories: Government policies of reliance on the private sector, the marketplace, and relative costs.

First, regarding the policy that the Navy has to follow, the Navy is very much bound by the principles of the 1936 merchant marine Act and must rely on the merchant marine for services to the extent practical. We have discovered over a long period of time that Congress is unwilling to appropriate funds for Navy ships

which would compete with the merchant marine, and this has been demonstrated over many years.

We continually get direction to rely on the merchant marine, to use their services, and this has been one of the dilemmas we have had in many ship projects over a good long period of time.

In the current program, there are approximately 50 ships under charter to the Navy, budgeted for annually, and our oversight committees oversee that budget.

Over the past 20 years, Navy procured services of 30 ships under build and charter in the economic environment that pertained at the time, excluding the TAKX and T-5 ships.

Navy first proposed acquisition of TAKX ships in the 1981 program. The ship was not funded by the Congress, and the Navy was directed to the investigate charter as well as purchase in the appropriations conference.

During 1981, the charter alternative was considered and included in the fiscal year 1982 revised budget. Similar missions were being satisfied by the merchant marine and it was clear that expansion of Navy activities into this role would not comply with the merchant marine policy.

However, in looking at the review, we concluded that chartering should be limited to commercial-type ships such as TAKX and the T-5 replacement tanker, but we excluded the hospital ship, and we excluded TAO oilers which serve as direct adjunct to the fleet and are currently in the appropriations budget.

Looking at the marketplace in 1981, we saw the shipbuilding industry that provided commercial ships, very rapidly declining. The potential closing of three or four major shipyards needed for the industrial basis was high and imminent.

If the industrial base was to be protected, Navy-supported programs were needed because commercial shipbuilding did not have good projects.

The only programs available were TAKX, and conversion of SL-7 ships purchased for the Reserve Fleet.

In addition, the shortage of jobs raised the possibility of union cooperation both in the shipyards and from the operating unions.

Relative costs of chartering and owning as we perceived the issue at that time.

Our analysis indicated that charter is preferable to purchase for the Navy under a wide range of conditions.

The initial attempts to evaluate the relative costs for us; that is, to evaluate the relative cost to the Government as a whole, I would classify as futile.

What we finally concluded was that a charter involving leveraged leasing would probably occur someplace else, if it didn't occur in the Navy, and therefore, there would be no additional impact on the Government as a result of the Navy's charter.

Now, with an additional year's work behind us, I know that particular belief has some challenge, and we will get to some of these issues a little later.

Looking back on the results of what we accomplished as a result of the TAKX and T-5 programs, we managed to expand sealift capability. Five foreign flag ships will be converted to U.S. flags, assuring their availability in time of war. Five new ships are being

built. Three ships were saved from default, and these were under Government loan guarantees, along with retention of a ship operator having important mobilization ships.

MERCHANT MARINER JOBS WILL BE INCREASED BY 750

Regarding the marketplace impacts, because we had the leasing tool to work with, we were able to hit the market at the right time. The average cost of the ships was $35 million below Navy estimates, and we saved over $450 million on the TAKX alone. T-5 ship estimates were $15 million below Navy expectation, saving $75 million.

We were able to get into an extensive competition for shipbuilding and ship operation. One of the reasons was because we were able to use commercial specification. U.S. Coast Guard certifications charter package allowed use of commercial specifications, contributing to cost reduction, rather than the specifications oriented more toward combatants that would have applied if the Navy had built ships.

Unions granted work rule and economic concessions for construction, as well as operation, thus improving the competitive position of U.S. industry.

Impact on operating costs attributable to the integrated procurement of services is $300 million in present value.

Three major shipyards in Quincy, Mass., Beaumont, Tex., and Sparrows Point, Md. were retained in the industrial base.

12,000 shipyard jobs were created/retained.

An unexpected event was the acceleration of program completion by 18 months, thus complying with military strategy needs and congressional direction. And this was because we were able to structure a program with built-in aspects of serial production that would be impossible in a procurement.

This also allows early phasing out of seven ships, at an estimated savings of $225 million in present value.

RELATIVE COST OF CHARTER AND BUY

We had a report on the table for about 6 months that our oversight committees in Navy demanded that we do. It received the independent review of the House Appropriations Committee surveys and investigations staff, who accepted it.

Another report which has not been discussed this morning, an independent report conducted by the Institute for Defense Analysis, accepted our rationale for making the calculations, but recently it has become a point of contention of whether or not we did it properly.

One thing that has been quite clear from the beginning and is still clear today is that there are no set guidelines for evaluating the relative cost to the Government of a transaction like the one we entered into. We had to make our estimates, our evaluation, our assumptions, as we went along in what we believed was a professional manner. We have displayed those reports as we have gone along with the committees that we deal with.

However, I would also like to point out from a business point of view that the Navy recognizes that the tax issues exist and has

taken action to minimize the cost to the Treasury by requiring charter deductions that would accrue because there are tax benefits.

Frankly, I would rather be up here this morning talking about this issue than why the Navy let them get away with windfall profits.

Mr. PICKLE. Would you say that again?

Mr. PYATT. In the environment that we structured these particular charters, we recognized that tax issues existed, and we were able to take those issues and press for reduction in prices to us. I would frankly rather be up here today talking about the use of taxing, the considerations that the taxes make on procurements, than be up here saying, why didn't you guys consider that taxes exist and why we let these contractors get away with windfall profits, because we didn't press hard enough on prices?

Mr. PICKLE. You have departed from your text here.

You are questioning whether Congress should have ever done this in the first place?

Mr. PYATT. No, sir, I am saying we wrote our arrangements within the tax rules and tax laws that existed at the time that we did the arrangements.

I believe that we have pursued——

Mr. PICKLE. Nobody is saying that you passed a new law or you got a new law passed. Of course, you are using the regular ACRS, and the tax benefits available. Are you inferring that we think you have created a special situation of these ships?

Mr. LONG. If I may, what he is saying is that the Navy in negotiating its price took into account the tax impact on the other parties to the transaction and didn't simply sign a contract at the same price as if those tax effects were not in being, so they used the tax impact effects to lower the price.

Mr. PICKLE. Of course, the availability of those taxes were there.

Mr. LONG. He would rather talk about the use of those than be criticized for not having used them.

Mr. PICKLE. For a moment would any of you have entered into this TAKX contract if the tax benefits were not available?

Mr. PYATT. We would have, because of our policy to rely on the Merchant Marine. I am sure we would have entered into the same kind of arrangements had these tax impacts not been there.

Mr. PICKLE. I can't understand. You say you would rather be trying to defend this procedure than you would defend the fact that some of these businesses could get windfall profits. You are admitting that they do get windfall profits?

Mr. PYATT. Businesses always negotiate for their best deal. We have to negotiate for ours.

Chairman RANGEL. I think it is clear, you are saying in negotiating on behalf of the U.S. Government, that you use the loopholes that were in existing tax law and use that as an incentive to get a good contract for the Navy?

Mr. PYATT. I wouldn't call them loopholes.

Chairman RANGEL. Incentives for the private sector, you used it for the benefit of the Navy, and we don't have any problem at all with that.

Mr. PYATT. And the Treasury.

Chairman RANGEL. That is the problem. We don't know whether or not you have discussed this with the Treasury.

Mr. PYATT. If we had not used them, our price would have been higher.

Chairman RANGEL. We understand that.

Mr. PYATT. OK.

Chairman RANGEL. We just don't understand how, in selling the tax benefit to the private sector, you were able to determine whether to lease or purchase was a "wash."

Now, the Secretary doesn't have that information, and I assume you don't have the information. Who, if anybody in the Treasury, did you discuss this "wash" with?

The fact that it was a good deal for the Navy doesn't necessarily mean it was a good deal for the taxpayer.

Mr. PYATT. In trying to make this calculation over the past several months, we have come to the conclusion that the standard for making the evaluation, the model to use is woefully out of date, if it exists at all, and that has been one that, as we went along and made our presentations to the committees, we had to estimate.

Chairman RANGEL. Well, that is because you had no guidelines, and the reason we are having these hearings is to see whether you and other Federal agencies should have guidelines.

Mr. PYATT. That has been the result. We tried to put together an estimate of what those impacts would be and we made that presentation. It stood the test of time for at least 6 months, including very detailed and thorough review by other independent people. Now it has become an issue.

Chairman RANGEL. None of these were Government people?

Mr. PYATT. They all were.

To the best of my knowledge, Treasury did not review or provide guidelines earlier on.

Chairman RANGEL. Even though we are talking about an expenditure?

Mr. PYATT. I have not until recently had contact with Treasury about these things.

Mr. PICKLE. Mr. Chairman, the gentleman brings up the question of the benefits and the profits that are involved, windfall profits and I don't understand just why you take that tack. Am I correct in making this analysis, because earlier this statement was made, the Joint Tax Committee said that the Navy got the benefit of 64 percent of these taxes, and that 36 percent of these tax benefits went to investors.

So you, the Navy, are getting the big hunk of any tax benefit or windfall, if you want to classify it as such.

I didn't want to throw that in there alone.

You are the one profiting as much as anybody and it may be in the public interest. I want to be sure that you don't think somebody else is making money and you are just trying to render a service.

Now, you may proceed with your testimony.

Chairman RANGEL. I just only hope that some other Government agencies, perhaps health and education, could be as innovative and creative as DOD has been. I have no problem with what you have done, either.

Mr. PYATT. In concluding, I think that the net result, had we not been able to enter into the chartering program for these ships, that we would have three closed shipyards, the Merchant Marine would shrink, and the Navy oversight committees would have been reluctant in providing funds to noncombatant ships, and therefore the tax program would still be slipping.

There are $800 million of program savings attributable to being able to use leasing as a chartering, as a procurement tool.

Without the availability of this tool, it wouldn't have happened.

[The prepared statement follows:]

STATEMENT OF EVERETT PYATT, PRINCIPAL DEPUTY ASSISTANT SECRETARY OF THE NAVY, SHIPBUILDING AND LOGISTICS

Mr. Chairman and Members of the Subcommittee on Oversight, I am Everett Pyatt, Principal Deputy Assistant Secretary of the Navy for Shipbuilding and Logistics. It is a pleasure to appear before you to discuss the TAKX program.

In 1936, Congress mandated a United States merchant marine policy—the development and maintenance of a merchant marine capable of serving as a naval and military auxiliary in time of war or national emergency. The TAKX program is an example of the Navy's continuing efforts in support of that policy and the U.S. merchant fleet.

The chartering of merchant ships by government agencies is not a new concept. During World War I and II, the predecessors of the Maritime Administration engaged in large-scale chartering of U.S. merchant ships for the carriage of vital war materials and supplies. The Navy, during World War II, chartered over 450 merchant ships for the same purpose. At the outbreak of the Korean War, the Navy had only six merchant ships under charter. Within 90 days, that number had increased to 216. Similarly, at the height of the war in Viet Nam, the Navy had over 200 ships under charter. Today, the Navy's Military Sealift Command continues to charter merchant ships, for periods ranging from the length of a single voyage to five years.

The "build and charter" method, used in the TAKX program, of chartering new construction ships under long-term agreements, is not a new concept. Since the early 1950's, the Navy has, with the foreknowledge and approval of Congress, used the build and charter method to obtain the services of one cargo ship and 29 tankers. The concept has proven valuable and a proper reliance on the merchant marine to furnish goods and services needed by the Navy. This, also, precludes Navy competition with the private sector for merchant marine services.

The services the Navy now has under contract for 13 TAKX prepositioning ships and two T–5 tankers, with options for three more, are basically commercial ships with crews and support. The contractor provides a transportation service—not a ship. The ships are not combatants, nor do they operate in direct support of the fleet. The TAKX ship is basically a roll-on-roll-off cargo ship with some specialized features. These include additional cranes to assist unloading in undeveloped areas, facilities necessary to provide limited maintenance and support of equipment carried for prolonged periods and facilities needed to carry the several kinds of fuel, as well as water, necessary to support military operations. Most of the cost being incurred is to enlarge existing ships, thus minimizing program costs by limiting the number of ships in the program. Again, these ships are not combatants, are not capable of amphibious operation, but are derivatives of roll-on-roll-off ships now in commercial trade. A similar mission is now being conducted by 17 ships at Diego Garcia. These are commercial ships, manned by civilians. Of these ships 13 are provided by the Merchant Marine, and four are provided under bareboat charter.

The other ship charter program in process is the T–5 replacement tanker. Two ships are under contract and the Navy has options for three more. These are Jones Act qualified ships which will replace five ships used in the distribution of clean fuel products to DOD facilities. The existing ships will not meet the 1985 pollution standards and are uneconomical to convert. In fact, we expect the capital and operating cost of the new ships to equal the operating costs of the old, inefficient ships.

Navy buys services of many kinds which involve the provision of capital equipment by contractors and in turn involve tax impacts. This includes transportation, computer services, communication services, research and development, just to name the most prominent. All of these activities receive the oversight of the Authorization and Appropriations Committees.

The plan to rely on the Merchant Marine for TAKX services was developed in the Navy, approved by the Secretary of Defense and OMB, then submitted to the Congress as part of the fiscal year 1982 program. Aside from the considerations being reviewed by this Committee, the chartering program allowed the use of commercial specifications rather than military with attendant cost reductions of approximately $35M per ship, schedule acceleration of 18 months, union manning concessions and the management advantages of an integrated operation from start to finish. Additionally, the ability to provide timely work precluded closing of three shipyards in Baltimore, Maryland; Beaumont, Texas; and Quincy, Massachusetts; necessary for the national industrial base.

The Congress recognized the special situation involved as related to ship charters with substantial termination liability and included provisions in the fiscal year 1983 Authorization Act for review of the charter versus buy analysis. Specifically included in Section 303 of the Act was the requirement that the Navy notify "the Committees on Armed Services and on Appropriations of the Senate and the House of Representatives of the proposed lease" and allow the elapse of "a period of thirty days . . . after the date on which such Committees receive such notification." Section 303 further provided that "any such notification shall include a description of the terms of the proposed lease and a justification for entering into such a lease rather than obtaining the vessel involved by acquisition."

Regarding the TAKX, Congressional review included a study by the House Appropriations Committee Surveys and Investigations staff, hearings by the House Armed Services Readiness Subcommittee and staff reviews by all four Committees. All four Committees provided written concurrence with the Navy plan to conclude a competition which began in October 1981.

I would like to submit for the record the letters containing the concurrences of the four Committees with the study of the Surveys and Investigations Staff. Three of the Committee letters, and the financial analysis, were previously made part of the record of the Readiness Subcommittee hearing of September 17, 1982.

The T-5 program also received written endorsements from three Committees, which I am also providing for the record, and the fourth allowed the 30-day review time stipulated by law to expire. The Navy waited an additional 53 days before notifying the contractor to proceed. This action was taken to avoid the increased program costs for the contractor and the Navy which would have resulted from further delay.

The Navy has made no attempt to conceal or hold from Congressional review any portion of this program. All issues raised in the review process have been investigated and, to the best of my knowledge, resolved before proceeding to the next step. We are proud of this situation.

Now, I would like to turn to the specific questions on the TAKX program raised in the Chairman's letter to the Secretary of the Navy, beginning with the chronology of the most significant events relating to the TAKX.

CHRONOLOGY

September 8, 1980—TAKX ships authorized by Congress.

October 1981—Request for Proposals allowing either charter or purchase of ships.

December 1981—Deputy Secretary of Defense approved convert and charter program for inclusion in FY83 Budget.

March 1982—Initial offers received.

August 1982—Source selection complete.

August 17, 1982—Congress advised of selection and review process defined in Section 303 initiated for six firm contracts and seven options.

September 17, 1982—House Subcommittee on Readiness holds hearing.

September 17, 1982—Four Committee endorsements received.

January 14, 1983—GAO opinion regarding termination liability accounting obtained.

January 14, 1983—Options for last seven ships exercised.

REVIEW

In addition to the review outlined above, the draft contracts were reviewed by the procurement staffs of the Military Sealift Command, Naval Sea Systems Command, Naval Material Command, the General Counsel of the Navy, and of the Secretary of Defense. We do not know the extent of review the contracts received by the offerors, but it is reasonable to assume that they were reviewed by counsel and management of the operators, shipbuilders, and financial institutions involved.

METHODOLOGY AND ASSUMPTIONS

The TAKX charters have been structured, to the maximum extent practicable, to utilize standard leveraged lease financing. A well-developed commercial market exists to provide this type of financing, typically for large equipment acquisitions such as ships and aircraft. In appropriate circumstances, leasing can provide a financing rate, or effective interest cost, that is significantly lower than the rate that would be charged in a conventional debt financing.

This is so because the lessors—frequently banks or finance companies—are entitled to the tax benefits available under the tax laws to owners of equipment. In a leveraged lease, the lessor is a passive owner of the asset, which is then leased, or bareboat chartered, to the actual user-lessee. The owner-lessor invests 20–50 percent of the cost of the equipment as equity, and borrows the remaining 50 to 80 percent from lenders. The lessee obtains the use of the equipment, and pays rent to the lessor. In the TAKX transaction, the lessee is providing services to the Navy by time-chartering the leased asset to the Navy.

A substantial part of the value of the tax benefits to the owner-lessor are reflected in a lower rent charged to the bareboat charterer, and in lower "charter hire" payments made to the bareboat charterer by the Navy; the tax benefits are thus not "windfall profits" of any kind to the lessors. The existence of a competitive market among owner-lessors, as well as the structure of the contracts, contributes to this result.

Industrial users of equipment who are contemplating leasing will customarily perform an analysis to determine whether leasing or purchasing the equipment is the more economic alternative. Such an analysis compares the cost of the rentals payable under a lease with the cost of purchasing the asset; it often involves very sophisticated issues regarding capital budgeting, dividend payouts and opportunity costs of alternative shareholder investments and is performed on an economic basis. The charter vs. purchase analysis performed by three independent groups for the TAKX Program was accomplished in the same fashion, although without regard to the equity-related issues and not adjusted for accounting type principles which is sometimes done in the Government. Thus, the results reflect what we believe to be the true economic consequence of the charter transaction to the Government.

In those analyses, in order to compare the charter payments over 25 years with the purchase cost, the present value of the charter payments was calculated as of the delivery date of the vessel. Present value analysis is a means of adjusting payments which occur over a period of time for the time value of money. Using a given interest rate, or discount rate, a series of payments over time can be expressed in terms of the present value which, if invested at that rate, would produce those payments. The 10 percent discount rate was selected for the primary analysis because it is stipulated by the Office of Management and Budget for Government Cost analyses in OMB Circulars A–76 and A–94 and in the DOD Cost Comparison Handbook.

This present value analysis was first used to analyze the relative costs of chartering and purchasing to the Navy alone (viewed separately from the effect on Treasury revenues). Secondly, the same method of analysis was applied to examine the relative costs of chartering and purchasing to the Government as a whole, that is, taking into account the negative and positive effects on Treasury tax revenues resulting from the charter transaction. We now understand that OMB accounting procedures do not recognize certain tax receipts considered by the independent studies.

A "Total Cost to the Government" analysis thus combines the results of the "Navy" analysis with the corresponding Treasury tax revenue effects, to show the overall net present value cost of chartering relative to purchasing.

The conclusions of the economic studies prepared by the several independent groups was that leasing of the TAKX and T–5 tankers could save the Navy 19 percent of the cost of the ships in present value dollars. It is recognized that a number of the assumptions utilized in the various studies such as the discount rate, whether it should be on an after-tax or pre-tax basis, and the tax rates of the various participants to the transaction, are variable and could change the magnitude of the results to the Government. However, with any reasonable combination of assumptions, the economic results range from 15 percent savings to 5 percent additional cost in chartering, rather than purchasing. However, regardless of the financial issues involved in "lease vs. purchase" type analysis, the operational, cost, and policy advantages of maximum reliance on the Merchant Marine for these services dominate the decision to utilize the chartering method.

TAX ADVANTAGES

As noted above, the TAKX leveraged lease transactions are structured so that the tax benefits available to the owner-lessors are reflected in the rent payable by the bareboat charterer and in the amount payable by the Navy. Under current law, these tax benefits are as follows:

Investment tax credit in the amount of 10 percent of the cost of the ships.

ACRS (formerly depreciation) deductions over five years in the amount of 100 percent of the cost of the ships (less 50 percent of any investment credit).

Interest deductions with respect to the interest paid by the owner-lessor on the loans used to finance a portion of the ships' cost.

Amortization deductions with respect to certain fees and expenses.

Under a true lease transaction, the lessor must take into income (and pay taxes on) rental payments made by the lessee. The tax liability on this rental income will, to some extent, offset the tax benefit referred to above. Nonetheless, a substantial portion of the net tax benefit accuring to the owner-lessors will be passed through to the bareboat charterer, and as a result, to the Navy through reductions of the rentals, as discussed above. It should be noted that the TAKX transaction will take the form of "true" or "guideline" leases under IRS rules, and will not utilize the "tax benefit transfer" or "safe harbor" leases that were the subject of legislation in 1981 and 1982.

LEASE CONTRACTS—INCREASED PAYMENTS

When each TAKX ship is delivered for charter service, the cost elements—the construction cost to be financed, and the applicable rental rate—will have been fixed. In fact, in the TAKX transaction, most elements of the construction cost were fixed at the time of award on a competitive basis. The exception is the interest rates to be charged on the loans during construction, and these have been fixed at a specified spread over an index; this gives the Navy the benefit of declining interest rates, while protecting the owner from unanticipated increases.

Continuing the analogy to a leveraged lease, as discussed above, in a leveraged lease, the rental rate reflects the expected value of the tax benefits available to the lessor. Consequently, once a lessor has commmitted itself to a rental rate, it will require in return, some contractural protection in the event those tax benefits prove to be unavailable. In commercial leases, such protections are often quite extensive. However, the TAKX contracts provide for very limited adjustments in such circumstances, namely (a) for amendments to Federal tax laws prior to delivery, and (b) for unavailability of the investment tax credit.

It should be noted that such adjustments can result in decreases as well as increases in the cost to the Navy, and that the potential for adjustments relating to the investment tax credits may be avoided by obtaining an IRS ruling prior to delivery. Moreover, prior to the delivery and after the first five years of the charter, the Navy has an option to purchase the ships.

Aside from the limited adjustment noted, and certain specified reimbursements relating to the operation of the ships, the contracts do not permit increased payments as a result of changes in the economy or other events.

THE OWNER-LESSORS

The TAKX Program consists of two stages for each ship: a construction (or reconstruction) period of 20–24 months, followed by a 25-year time charter. For the construction period, interim financing has been arranged, to be replaced by the permanent charter financing upon delivery. In the current market, it is customary and advantageous to place the permanent financing within six to twelve months prior to delivery. Thus the specific owner-lessors have not yet been selected. The contract obligates the offerors to obtain the required permanent financing, which will be done on a competitive basis, at the direction of the Navy. The owner-lessors are expected to be major banks and other financial institutions, many of which have participated in the discussions held to date.

In the TAKX leveraged lease, each ship will be "bareboat chartered" to a vessel operating company, who will in turn time charter the ship to the Navy. Under the Time Charter, the operating company is responsible for manning the ship, as well as for all other management and operational matters related to the required transportation service. The ships will be U.S.-flag vessels, crewed by U.S. merchant mariners.

Consistent with the nature of a lease, as well as IRS guidelines, at the end of the charter period (which extends for a substantial part of the ship's life), the ship will

continue to be owned by the lessors, although the Navy has certain options to purchase the ships.

LEGAL FEES

The reference to "IRS Counsel Fund" apparently stems from including legal fees in the Basic Capitalized Costs. One of the common items of expense in a program of this kind is the fee payable to tax counsel for preparing and presenting the request for an advance IRS ruling customarily sought in a leveraged lease transaction. No legal expenses incurred in connection with lawsuits, actions, disputes or similar proceedings in which the Government is an adverse party may be included in the Basic Capitalized Costs. The fees may be adjusted to reflect actual costs, but cannot exceed the amount proposed by the offeror.

CHARTER PERIODS

The TAKX charter periods were structured in five-year periods to coincide with the DOD Five-Year Defense Plan which firmly established the requirements for the services provided by these ships. A 25-year contract was not utilized because it would have exceeded such firm requirements; in addition, the five-year intervals provide the Navy with periodic opportunities to terminate the contracts without incurring operational type termination costs.

TRADITIONAL PROCUREMENT

These contracts do not depart from traditional DOD procurement of Ocean Transportation services. The Military Sealift Command (MSC) as DOD Single Manager for Ocean Transportation, has chartered (leased) literally thousands of ships since 1950. While such charters are usually for existing ships and run for less than five years, MSC has acquired the services of 30 new ships utilizing long-term charters under similar build and charter programs since 1952. In the TAKX Program, to the extent that the proposed agreements to charter and time charter deviated from required clauses in the Defense Acquisition Regulations, approval of the deviations was obtained from the Office of the Secretary of Defense. The TAKX procurement departs from previous build and charter programs only in the magnitude of the cost involved, the degree of refinement to achieve the lowest charter hire rates and the fact that eight of the ships involve major reconstruction of existing ships. It is also noted that only one of the previous build and charter programs involved a dry cargo RO/RO ship, with the rest involving tankers.

You also requested that we discuss our general leasing activities. The Navy engages in the leasing of a wide variety of equipment, in such categories as transportation, automatic data processing (ADPE), communications and electronics, industrial and materials handling, and word processing. I would also include within these categories the bareboat chartering of ships by MSC. Of the different types of ship charters, only a bareboat charter is the equivalent of a lease of equipment—the owner provides us with the ship, and MSC crews and operates it. In the other types of ship charters I discussed earlier—time and voyage charters—the owner crews the ship and operates it and provides MSC with the service of cargo carriage. Thus, time and voyage charters are actually service contracts rather than leases.

The Navy primarily uses long-term leases for ADPE. We currently have 12 such leases in effect, only one of which was entered into in 1982. Several more are under consideration for future action. Long-term leasing of ADPE is only utilized after a comparative cost study, performed in accordance with GSA property management regulations, clearly demonstrates that a lease offers a greater advantage to the Government than an outright purchase.

Over the past five years, the Navy's total expenditures for equipment leasing have varied, reflecting increases and decreases in specific categories. For example, categories such as ADPE and word processing equipment have gradually increased, while others such as industrial equipment have alternately increased and decreased. Leases of vehicles are currently at lower levels than in previous years.

Outside of ADPE, our equipment leases are mainly of short duration, reflecting short-term requirements for particular items. In these instances, rentals and leases are used because of their obvious cost-effective advantage over outright purchases.

U.S. SENATE,
COMMITTEE ON APPROPRIATIONS,
Washington, D.C., September 14, 1982.

Hon. JOHN F. LEHMAN, Jr.,
Secretary of the Navy,
Washington, D.C.

DEAR MR. SECRETARY: The Committee has no objection to the lease proposal described in Under Secretary Goodrich's letter of August 17.

With best wishes,
Cordially,

TED STEVENS,
Chairman, Subcommittee on Defense.

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ARMED SERVICES,
Washington, D.C., September 17, 1982.

Hon. JOHN F. LEHMAN, Jr.,
Secretary of the Navy,
Washington, D.C.

DEAR MR. SECRETARY: This is in response to Under Secretary Goodrich's letter of August 17, 1982 notifying the committee of the Navy's intent to contract for ship operating services for the TAKX prepositioning ship program. The committee interposes no objection to these contracts.

As a result of our review of the TAKX program it has become clear that existing authorization procedures are not adequate. The committee believes that additional legislation will be necessary to ensure timely and effective Congressional review of any future long term lease proposals and that such review should be accomplished prior to the release of a request for proposal.

The acquisition of the TAKX maritime prepositioning ships by lease rather than purchase shifts the cost of the vessels from the procurement account into the operation and maintenance account. As you may know, the committee initiated legislation to require annual authorization of Department of Defense operation and maintenance appropriations to promote readiness through a better balance between the investment, personnel and operating accounts. Although I believe we have managed to achieve a better balance between these accounts over the past two years, the fact remains that the fiscal year 1983 Defense Authorization Act contains a 24.6 percent real growth for procurement compared to about three percent for operation and maintenance.

The projected average annual cost of $216 million ($16.6 million times 13 TAKX ships) in lease payments represents a significant transfer from the procurement to the operation and maintenance accounts. Roughly, it equates to one percent of the fiscal year 1983 Navy O&M budget. Because 80–85 percent of the Navy O&M budget is fixed cost, the addition of one percent of additional fixed cost translates into over a five percent decrease in discretionary areas. The discretionary areas are most commonly associated with readiness and quality of life—training, depot maintenance, and real property maintenance. Thus, major transfers of investment costs into the operation and maintenance account could result in the degradation of future fleet readiness.

Sincerely,

MELVIN PRICE, *Chairman.*

U.S. SENATE,
COMMITTEE ON ARMED SERVICES,
Washington, D.C., September 14, 1982.

Hon. JOHN LEHMAN, Jr.,
Secretary of the Navy,
The Pentagon, Washington, D.C.

DEAR MR. SECRETARY: Having informed the Committee of your intent to convert and charter certain vessels under the TAKX program, this letter is to confirm that the Navy is in compliance with Section 303 of the fiscal year 1983 Defense Authorization Bill.

The Committee interposes no objection to this program, as outlined in your letter of August 17, 1982.

Sincerely,

JOHN TOWER.

HOUSE OF REPRESENTATIVES,
COMMITTEE ON APPROPRIATIONS,
Washington, D.C., September 16, 1982.

Hon. JOHN LEHMAN, Jr.,
Secretary of the Navy,
The Pentagon, Washington, D.C.

DEAR MR. SECRETARY: By letter dated July 30, 1982 you indicated that the Navy would "withhold any firm contractual arrangements" until the Committee had completed its review of the proposed TAKX acquisition plan. This review is now substantially complete. The remaining concerns center on three primary issues.

As a result of the September 1, 1982 Surveys and Investigations report to the Committee, it is clear that the Navy's proposal to lease rather than purchase TAKX vessels is the proper approach. However, the S&I report questions the possible adverse impact on Navy Industrial Fund operations through using existing obligational authority rather than requesting specific congressional approval of additional authority for both lease costs and termination liabilities. I am enclosing a copy of the S&I report for your review.

The second concern that you may wish to address is the responsibility of the Navy to take full cognizance of the advantages of using American constructed ships. In your letter of May 28, 1982 you stated that "the Navy intends to maintain its policies in support of the American Merchant Marine and the American shipbuilding industry." Since 5 of the ships selected for the TAKX program are of foreign origin while available U.S. ships were excluded, the Navy may face serious challenges concerning its compliance with various buy-American provisions.

Finally, I have learned that one of the unsuccessful competitors has filed a formal protest against the award of the TAKX contract. This cloud over the program raises the possibility that if the Navy proceeds with the present award and the protest is sustained, the contract could be canceled. This would result in unnecessary delay and cost.

The Maritime Prepositioning Ships program is a potentially important contribution to our national security. Consequently the Committee does not disapprove of proceeding with the proposed contract award. However, the Navy should satisfy itself that the above concerns will not be an impediment to a timely and cost-effective completion of the TAKX program.

Sincerely,

JOSEPH P. ADDABBO,
Chairman, Defense Subcommittee.

Enclosure.

SEPTEMBER 1, 1982.

Memorandum for the Chairman
Re TAKX Ship Acquisition Program for the U.S. Navy Maritime Preposition Ship Program

In response to a Committee request dated July 23, 1982, an investigation of the relative merits of lease versus procurement for the TAKX ships associated with the Department of Defense Maritime Prepositioned Ship (MPS) program was conducted. The investigation has been completed and the results are attached. Since the Navy planned to contract for the operation of the TAKX ships regardless of the method of acquisition, the investigation focused on the cost to the Government asssociated with the Navy's plan for the long term lease of these ships.

Respectfully submitted,

C. R. ANDERSON,
Chief of the Surveys and Investigations Staff,
House Appropriations Committee.

TAKX Ship Acquisition Program for the U.S. Navy Maritime Preposition Ship Program

BACKGROUND

The TAKX Maritime Prepositioning Ships (MPS) program was authorized in August 1979 by the Secretary of Defense and is a long term program designed to establish a rapid deployment capability for the Marine Corps using roll-on/roll-off (RO/RO) type ships. The MPS–TAKX ships will be loaded with equipment and supplies configured in sets to support three Marine Amphibious Brigades (MAB's) for a 30 day period. The ships, operated by civilian maritime crews, will then be berthed near possible crisis areas. The Navy originally proposed to have ships for the first MAB by fiscal year 1983, the second by fiscal year 1985, and the third by fiscal year 1987. These dates were subsequently changed to the 1st qtr fiscal year 1985, 4th qtr fiscal year 1985, and 2nd qtr fiscal year 1986 respectively, and are now dependent on Congressional approval of contract award by early September 1982. Achievement of a capability for the 1st MAB could slip approximately 6 months to the 2nd qtr fiscal year 1986.

Initial Navy requirements called for the construction of 15 new RO/RO ships for the MPS fleet, each ship to contain equipment for 1/5 of a MAB. Due to new ship cost considerations, and the early operational requirement, the Navy subsequently decided to build eight new ships and convert four existing RO/RO ships with each ship capable of containing equipment for 1/4 of a MAB. A later change proposed the purchase of six new ships and the conversion of six existing ones by purchase or lease. The Request for Proposal issued in October 1981 by the Naval Sea Systems Command NAVSEA) to accomplish this was amended in December 1981 to permit only a lease-charter arrangement whereby the contractor will arrange for either the construction of new ships or the conversion of existing ships to meet Navy requirements. When the ships are ready, the contractor will lease the ships to the Navy and subsequently operate them for the Navy using civilian maritime personnel. The total number of ships planned varied between 12–15. Depending on size, each ship was to be capable of containing equipment for either 1/4 or 1/5 of a MAB,

The change to a total lease program resulted from a study conducted by a prominent national accounting firm engaged by the Office of the Assistant Secretary of the Navy for Shipbuilding and Logistics (ASN–S&L). The study was to determine the economic aspects of lease versus purchase of the TAKX ships. Using a present value economic analysis, it concluded that the Navy could lease-charter a ship for as much as 35 percent below its acquisition cost.

A second economic analysis model based on the intital cost proposals submitted in response to the amended RFP was developed by an economic consultant engaged by NAVSEA. This analysis, completed in July 1982, also indicated that lease-chartering represented a significant savings over purchase for both the Navy and the Government as a whole.

This program has caused a great deal of controversy within the Navy and industry. Historically, the Navy has purchased ships when embarking on major programs such as the TAKX and some officials within the Navy would rather continue building and buying new ships. Navy ship leasing has been limited and is generally undertaken for commercial type ships such as fuel tankers. Over the years about 30 ships have been obtained by the Government through build and charter arrangements. However, it has been 10 years since a relatively long term charter of this type has been negotiated. The fact that the TAKX program ships are more aligned to military missions than previous leases has also added to the overall controversy of this lease concept. Although the long term leasing of capital equipment has been relatively common in industry, the dollar size of the TAKX program and its associated financial aspects initially posed problems to industry officials.

The financial aspects of the RFP were originally opposed by industry primarily because the contractor was required to assume literally all the risk associated with interim and long term financing, tax determinations, potential tax changes, and equity repayment.

After a series of negotiations with potential contractors, 17 amendments to the RFP were issued and industry's concerns were largely eliminated by the Government's assumption of most of the financial risk. For example, the Government now: Assumes the risk of (and receives the benefits from) actual interest rates; assumes the risk of 100 percent debt financing if equity investors are unavailable; takes the full risk of (and receives the benefit of) the availability of tax credits, thereby guaranteeing a reasonable rate of return to the contractor; and includes both long term debt and equity as part of capital lease costs.

It appears that the concerns of industry have been alleviated and discussions with contractor officials indicate no significant financial problems. Further it appears that Government can benefit from its assumption of risk, especially if economic conditions improve. With the elimination of the major financial risks, the competitive aspects of the lease focused largely on lowest overall costs. The offerors, of necessity, had to negotiate with a number of shipyards regarding availability, capability and price and there is evidence in the contractors' offers that considerable competition took place.

COST ANALYSIS—LEASE VERSUS PURCHASE

In considering the alternatives of lease versus purchase, two different types of analysis can be utilized—total cash flow and present value. Cash flow analysis consists of nothing more than comparing the total cash purchase price to the total monies expended as lease payments over the entire term of the lease. Cash flow is a simplistic approach which ignores the inherent cost of borrowing money and inflation.

Present value analysis is considerably more complicated, and expresses total dollars to be spent over the life of the lease in terms of today's dollars. If inflation and alternative investment opportunity are considered, cash on hand today is more valuable than the same amount of cash received in the future. Present value analysis recognizes this time value of money and "discounts" the stream of rental payments made during the term of the lease to determine the "present value" of the time payments.

When the United States Government operated on a cash basis, the use of present value analysis for Governmental programs was generally considered unrealistic. However, since the Government must now borrow money, many economists believe it is appropriate to use present value analysis which considers the cost of debt and the time value of money.

To evaluate the lease versus purchase costs in terms of present value, several factors have to be considered. The two major factors that have the greatest impact on the cost of leasing are interest rates and tax incentives.

Industry officials claimed that without the concession by the Government to assume the interest rate risk, the Government would have been required to pay a premium on the loans because interest rates would have to be "locked in" for a lengthy period of time prior to their actual need. As a condition of the Government assuming the risk of actual interest rates and associated fees, any savings from reduced interest rates must be passed to the Government. To assure this, each offeror selected for the program must obtain Government approval for the timing and conditions of debt placement. The long term debt can therefore be placed anytime prior to the Navy's taking control of the ship. Since many economists believe that interest rates will stabilize at lower rates than are currently available, the cost of the TAKX program could be lower than if the loans were placed at the present time.

Leasing from private industry will create tax incentives such as investment tax credit (ITC) and depreciation. For the TAKX program, the lease could be recognized by the IRS as either a true property lease or a service lease. Some IRS officials believe the leases will be treated as true property leases. If the transaction is treated as a true property lease, the lessor (the ship owner) would be eligible for the tax benefit of depreciation, but would not be able to use the ITC because property leased to a tax exempt entity, such as the Navy, does not qualify for this benefit. Under a service lease ruling, the tax benefits of both the ITC and depreciation would be available to the lessor. Any tax benefits received by the lessor will decrease his cost and reduce the Government's lease payments.

From the Navy's point of view, a service lease ruling by the IRS would provide the most optimal leasing method producing the greatest savings over purchase. For each tax incentive the shipowners are able to use, the cost to the Navy will decrease.

These tax advantages, which were enhanced by the Economic Recovery Tax Act of 1981, are the significant factors which make leasing advantageous for business and potentially the Government. This new tax law allows companies to recover their capital investments over a 5 year period under a new depreciation method referred to as the Accelerated Cost Recovery System (ACRS). If for some reason the ships to be leased to the Navy under this program do not qualify for the ACRS, or if the tax laws change, lease costs over the life of the lease will increase since the Government is assuming all risk in regard to tax incentives. Changes in these tax advantages (under consideration by the Congress for the past several months) and general un-

certainty over future potential changes had been an apparent cause of concern to the offerors responding to the TAKX program.

When considering the effect of tax incentives, the overall cost to the Government as a whole has to be considered. Some officials believe that the overall cost to the Government will be greater than the cost to the Navy because of tax revenue losses resulting from the tax advantages created by the leasing agreement. Many financial analysts disagree and believe the costs are essentially the same. They contend that consideration of revenue losses is inappropriate because firms motivated to shelter income would find other opportunities to do so if the TAKX program did not exist.

If tax revenue differences are considered, then the Government and the Navy can be viewed as two separate entities for the purpose of examining the effects of the tax incentives. If the tax deferral benefits of either or both the ITC and ACRS are available for use by the shipowners and passed thru to the Navy as required, the corresponding lease costs to the Navy will be less. However, under the present value method, the total lease cost to the Government as a whole could be more when both the ITC and/or ACRS are utilized. In either event, using present value analysis and the OMB directed 10 percent present value discount rate, leasing the TAKX ships is advantageous to the Navy and the Government at all long term interest rates less than 18–19 percent.

The following charts indicate the anticipated present value costs and cash flows to both the Navy and the Government for the tentative contracts awarded by the Navy to General Dynamics (5 ships), Waterman Steamship Corporation (3 ships), and Maersk Lines (5 ships). The charts are based on the costs provided by the Navy as averages of the actual costs proposed for the TAKX ships and reflect the tax changes recently enacted by the Congress. These costs, developed by a Navy consultant using a commercial leasing model, were generally substantiated by the Investigative Staff using an economic model independently developed by the Institute for Defense Analysis (IDA). As can be seen in the chart, the present value of the total lease payments is less than the purchase price.

PRESENT VALUE COST ANALYSIS—10 PERCENT DISCOUNT RATE, 13 PERCENT INTEREST RATE

[In millions of dollars]

	Navy		Government	
	Per ship	Total of 13 ships	Per ship	Total of 13 ships
Purchase	184.01	2,392.13	184.01	2,392.13
Lease with ITC and ACRS [1]	148.86	1,935.18	155.64	2,023.32
Lease with ACRS only [1]	168.46	2,189.98	152.39	1,981.07

[1] Stream of lease payments discounted to present day dollars.

Although the TAKX ship acquisitions are structured on a 25 year lease basis, the Government has the option to terminate the ship leases at the end of 5 years or anytime thereafter. Should the Government decide to exercise its option to terminate, the present value of total lease payments plus termination cost after 5 years will always be less than the original purchase price of $184.01 million.

CASH FLOW COST ANALYSIS

[In millions of dollars]

	Navy		Government	
	Per ship	Total of 13 ships	Per ship	Total of 13 ships
Purchase	184.01	2,392.13	184.01	2,392.13
Lease with ITC and ACRS [1]	440.33	5,724.29	333.63	4,337.19
Lease with ACRS only [1]	497.87	6,472.31	350.42	4,555.46

[1] Sum of lease payment over the life of the lease.

As previously stated, cash flow analysis is a simplistic approach which ignores the time value of money and the actual cost of borrowing by the Government. If the Government's cost of borrowing money is considered, the cash flow associated with purchasing would increase dramatically. For example, if the purchase price of

$184.01 million was borrowed for 10 years @ 13 percent interest, the total payback in year 10, including compound interest, would be $624.6 million.

FUNDING THE TAKX PROGRAM

The Navy intends to fund the lease and operation of all of the TAKX ships with O&M dollars from the Navy Industrial Fund (NIF). The rationale for this decision is based on a previous Comptroller General (CG) Decision (B–174839, March 23, 1972) concerning the use of the Navy Industrial Fund for a relatively inexpensive tanker ship charter hire program. The use of the NIF for the costly long term lease of the TAKX ships was reported to have been an issue discussed at senior level program reviews because of potential impacts to other NIF operational programs. It is obviously in the Navy's interest to acquire these ships thru the NIF with O&M funds because it does not impact their ship appropriations and new ship construction program.

There are potentially critical problems with the use of the NIF in this manner. Ordinarily, industrial funds are operating funds with relatively short term cash flows. The TAKX program places long term obligations on the fund and it will be 2 to 4 years before any associated user revenues are received. More significantly, obligations made on the fund cannot exceed unobligated balances and must include both lease costs and contract termination liabilities at the time of the obligation. Because of the magnitude of the TAKX program and the amount of the unobligated balance at the time the Navy made the tentative contract award, it was able to award a firm contract for only 6 of the 13 ships required for 3 MAB's. The other 7 ships are contractual options. The unobligated balance in the NIF at the time of the conditional contract award on August 17, 1982 was approximately $1.8 billion. The obligation for the six "firm ships" contracted for on August 17, 1982, was $1.421 billion which included $.807 billion of termination liability. The obligation required for the remaining seven ships is $1.642 billion which includes $.947 billion of termination liability. The total 13 ship TAKX program is therefore $3.063 billion which includes $1.754 billion of termination liabilities.

Navy officials advised that accounting procedures allow them to transfer the termination liability costs from an obligation to a contingent liability listed in a footnote after the contract award date. This procedure will reduce the direct obligations on the NIF and create the appearance of a larger unobligated balance. At the present time, the Navy plans to closely monitor the status of unobligated funds in the NIF and award a contract(s) for the remainder of the ships when an adequate amount of unobligated funds exist. The Assistant Secretary of the Navy (Financial Management) believes that under this concept and based on the past history of fluctuations in fund balances, there is "a reasonable probability" that a sufficient amount of unobligated funds will be available to complete the program during the next few months. This is extremely important because the Navy is committed to exercise the options for the remaining ships no later than January 4, 1983 and the costs identified in the previous charts are based upon contracts for all 13 ships. The costs per ship increase if the quantities are reduced. The mission capabilities for the Marine Corps are also obviously diminished if the full 13 ship program is not completed.

The procedure of transferring the termination costs from a direct obligation to a contingent liability after contract award has been a subject of controversy. Previous CG decisions have reportedly not addressed this particular issue. The Navy however, has not requested clarification from the CG, Defense Industrial Fund officials or the OSD Assistant General Counsel (Fiscal Issues). Navy officials believed that "this procedure is within the letter and spirit of the law" and have plans to use the NIF in this manner for other programs such as the T–5 tankers.

PROGRAM COSTS

The TAKX program consists of several cost factors other than the ship acquisition, as outlined in the following charts:

LIFE CYCLE COSTS FOR THE TAKX SHIPS

[In millions of dollars and fiscal years]

Type of cost	1984	1985	1986	1987	1988	Total 1984–88	Total 1984–2011
Ship lease		62.97	185.91	201.10	201.10	651.08	5,594.76
Operating contract		40.70	127.08	140.76	142.12	450.66	4,558.78

LIFE CYCLE COSTS FOR THE TAKX SHIPS—Continued

[In millions of dollars and fiscal years]

Type of cost	1984	1985	1986	1987	1988	Total 1984–88	Total 1984–2011
Fuel [1]	1.33	29.38	58.43	61.41	61.41	211.96	1,502.02
Maintenance and repair [1]	.68	12.31	25.48	26.68	26.68	91.83	652.53
Total	2.01	145.36	396.90	429.95	431.31	1,405.53	12,308.09

[1] Estimated in 1982 dollars.

In addition to these ship costs there are other considerable costs associated with the TAKX MPS program. The MPS concept requires that duplicate sets of Marine Corps equipment be procured and maintained—one for active forces in the United States and one on the prepositioned ships to support rapid deployment. The equipment stored on the MPS ships must be maintained, repaired and replaced periodically. Navy and Marine Corps costs for the TAKX MPS program are estimated to be approximately $2.7 billion from fiscal year 1984 to fiscal year 1988 as indicated in the following charts:

INITIAL COSTS FOR PREPOSITIONED EQUIPMENT

[In millions of dollars and fiscal years]

	1982	1983	1984–88	Total thru 1988
Navy:				
Aviation ground support	65.9	65.5	250.0	381.4
Aviation spares			60.0	60.0
TAVB (Marine aviation support ship) [1]			180.0	180.0
Subtotal	65.9	65.5	490.0	621.4
Marine Corps (3 MAB's):				
Equipment procurement (PMC)	360.7	183.5	613.2	1,157.4
Ammunition procurement (PMC)	([2])	([2])	([2])	[2] 525.0
Parts for stockage (O&M)		8.0	79.6	87.6
Stock fund (O&M)		7.5	15.6	23.1
Maintenance (O&M)			144.8	144.8
Subtotal	360.7	199.0	853.2	1,937.9
Total	426.6	264.5	1,343.2	2,559.3

[1] Plans for another convert-lease/charter ship for aviation support.
[2] Assumed to be available from general yearly ammunition procurement.

Cash flow summary—fiscal years 1984–88

	Millions
Navy costs:	
Ship life cycle cost	[1] $1,405.53
Aviation support	490.00
Marine Corps	853.20
Total	2,748.73

[1] Excluding termination costs.

Over the past decade, the Army's NATO POMCUS (Prepositioning of Materiel Configured to Unit Sets) has been a subject of concern to the Committee due to its high cost and the apparent vulnerability of its storage sites to enemy action. These concerns were graphically expressed in the language of the fiscal year 1982 Appropriations Act which denied the Army funds for additional POMCUS equipment in Europe and urged the Department of Defense to expedite fast sealift programs. Problems evidenced in the NATO POMCUS program could be magnified in the MPS program because:

Airfields must be available close to equipment offloading sites;
Suitable beaches or ports must be available; and

There must be no opposition to unloading the ships.

Other problems have also been identified with respect to the maintenance of stored equipment. For example, experience to date shows that vehicles prepositioned on ships develop hydraulic leaks caused by excessive temperatures. Other potential problems, such as the effects of sea climate on the equipment, dehumidification, and vulnerability of the ships, have yet to be thoroughly evaluated. MPS maintenance and logistics problems are also compounded because the ships must be periodically moved from their staging area possibly for as long as 40 days, two times per year.

In light of past history, the potential problems, and the significant costs associated with the prepositioning of equipment, the validity of the MPS concept is apparently being questioned by some Department of Defense officials. As a result, the Defense Review Board, in August 1982, directed OSD (PA&E) and the JCS to conduct new studies of Sealift and Prepositioning and Airlift Augmentation requirements.

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON ARMED SERVICES,
Washington, D.C., October 8, 1982.

Hon. JOHN F. LEHMAN, Jr.,
Secretary of the Navy,
Washington, D.C.

DEAR MR. SECRETARY: This is in response to your letter of September 29, 1982 notifying the committee of the Navy's intent to execute long term time charters for T-5 tankers. The committee interposes no objection to the contract.

The concerns I expressed to you in my letter of September 17, 1982 on the TAKX program also apply to the T-5 tanker program.

Sincerely,

MELVIN PRICE, *Chairman.*

U.S. SENATE,
COMMITTEE ON ARMED SERVICES,
Washington, D.C., November 8, 1982.

Hon. JOHN LEHMAN, Jr.,
Secretary of the Navy,
Washington, D.C.

DEAR MR. SECRETARY: Having informed the Committee of your intent to build and charter two vessels under the T-5 tanker program, this letter is to confirm that the Navy is in compliance with Section 303 of the fiscal year 1983 Defense Authorization Act.

At the present time the Committee interposes no objection to this program.

Sincerely,

JOHN TOWER.

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON APPROPRIATIONS,
Washington, D.C., November 8, 1982.

Hon. JOHN LEHMAN, Jr.,
Secretary of the Navy,
Washington, D.C.

DEAR MR. SECRETARY: The Department of Navy recently notified the Defense Appropriations Subcommittee that a contract, to build and charter five T-5 Tankers, was awarded to Ocean Carriers, Inc. of Houston, Texas.

The Committee has reviewed all facets of the T-5 Tanker contract award including the Department's decision to build and charter these vessels, and interposes no objection to the action taken by the Department.

Sincerely,

JOSEPH P. ADDABBO,
Chairman, Defense Subcommittee.

Chairman RANGEL. Mr. Mosemann.

STATEMENT OF LLOYD K. MOSEMANN II, DEPUTY ASSISTANT SECRETARY FOR LOGISTICS AND COMMUNICATIONS, DEPARTMENT OF THE AIR FORCE

Mr. MOSEMANN. The Air Force appreciates the opportunity to provide the committee with background information concerning our long-term leasing of high cost property items such as aircraft.

I will depart from my statement and perhaps amplify a few other points.

With respect to the past, the Air Force has really had virtually no lease arrangements such as are being discussed today. We have leased automated data processing equipment, vehicles, and some family housing; the latter primarily in overseas areas. With these exceptions, which it is my understanding the committee does not plan to address in these hearings, we have had no long-term leases for major equipment.

Frankly, until recently, it has been our belief that it is cheaper to buy and own rather than to lease. Even with respect to automated data processing equipment, we are more and more either buying the equipment outright or are leasing for a short period after which we exercise an option to purchase.

However, we are now considering several lease programs. In our two approved programs, we concluded that lease is the most responsive means by which to satisfy some rather unique, atypical, Air Force mission requirements. The two lease projects which we are currently pursuing involve the C–140B and CT–39 replacement aircraft programs.

Congress has advised us for the past 2 years to acquire replacements for the aging, range- and payload-limited C–140B aircraft currently operated by the 89th Military Airlift Wing at Andrews Air Force Base and Ramstein Air Base, Germany. The current requirement is for a fuel efficient aircraft capable of carrying at least 14 passengers over transcontinental ranges.

We recognize that replacement is long overdue, and are pursuing that acquisition through normal procurement channels. We are looking to procure commercially available off-the-shelf aircraft that satisfy the requirement. However, we have found that they can be obtained 1 year sooner by leasing the first 3 of 11 aircraft at a cost within current budget constraints.

This approach provides the greatest capability in the shortest time. This is a short-term lease as a prelude to a purchase.

We also have explicit congressional authority to proceed with a second program to lease 120 aircraft as replacements for the CT–39 operational support aircraft. In the continuing resolution authority there is text tying the CT–39 replacement to another program for European distribution system—EDS—aircraft. However, the two programs are, in fact, separate and distinct and require aircraft of distinctly different capability. We plan to procure the EDS aircraft in the traditional acquisition manner, and I will not address it further here.

The CT–39 replacement program is aimed at replacing 22-year-old, 6-passenger Sabreliners with an equivalent off-the-shelf executive jet. The total requirement is for 120 operational support aircraft. Operational support aircraft have an amalgam of time sensi-

tive wartime contingency missions including command and staff movements, medical and security personnel, and intelligence support, including debriefing arrangements for prisoners of war.

The existing CT-39 airplane, because it is old, has numerous problems. In the last 10 years we have had three major structural refurbishment programs, and the end is not in sight. If we keep the airplanes in service, we are faced with an estimated $120 million bill for accomplishing major wing reskinning, replacements of certain portions of the longeron and corrosion control and minor structural repairs within the next 5 years. In addition, because the aircraft is so old, it is fuel inefficient. Replacement aircraft will use 35 to 50 percent less fuel—over $70 million over 8 years at recent prices. Further, maintenance manhours per flying hours will be only 2 to 3 hours for the replacement aircraft as compared with 12.5 hours for the CT-39.

We have discussed replacement of the CT-39's almost every year for the past 5 years; however, in a military environment already short of combat arms, the CT-39 replacement has not successfully competed with higher priority requirements.

Our thinking concerning the replacement of this aircraft, however, changed dramatically last summer when we received an unsolicited proposal from the manufacturer of a small business jet of the type that could be an off-the-shelf replacement for the CT-39. This proposal contained some interesting facts and figures; namely, that we could lease new aircraft, obtain contractor maintenance of those aircraft, and operate the aircraft for considerably less funding than we are presently spending.

In fact, over 8 years it will cost us somewhere between $100 million and $150 million less to lease the airplanes and to operate these new airplanes, than if we were to retain and maintain the existing aircraft.

As we studied the proposal, three things became obvious:

One, the proposal was fiscally attractive. Its attractiveness derived in some measure from the depressed condition of the aircraft manufacturing industry, which permitted the contractor to give us a rock bottom price for the new aircraft—hence a "window of opportunity" exists for at least a short period.

This window of opportunity is a relatively short one, but the fact that the aircraft industry was depressed, and this small jet industry particularly was depressed, gave us indications based on the unsolicited proposal that a rockbottom price would be available if we could rather quickly to obtain the aircraft.

The second point that came to our attention, was that it would not be appropriate to award a sole source contract on the basis of the unsolicited proposal, as there are a number of other equally capable off-the-shelf aircraft that could be used to replace the CT-39. We generally find that there are additional savings when we move into a competitive environment.

The third consideration was a determination that we would need explicit congressional authority to enter into a long-term contract of the lease type.

We rejected the unsolicited proposal, but we did proceed to obtain congressional authority to enter into the lease arrangement.

This authority, specific to this case, was granted in the continuing resolution authority approved and signed into law in December 1982.

We did not request any additional funds because the lease arrangement will cost us considerably less in the operation and maintenance of existing aircraft to the tune of about $100 to $150 million minimum over the next 8 years.

In addition to these two congressionally approved programs, there are two other programs under consideration and discussion within the Air Force that could conceivably involve lease arrangements in the future.

For example, the Air Force is now conducting an analysis of three prospective leasing arrangements, one of which does include leverage leasing, which has been prompted by proposed alternative strategies to incentivize and fund the civil reserve air fleet enhancement program.

Now, this program, you may recall, is a program whereby the Air Force has been under congressional mandate for a number of years to arrange with commercial airlines to modify their B–747, and DC–10 passenger aircraft, to include a cargo-carrying capability.

The traditional approach to this has not been successful, and it has been suggested to us by a Military Airlift Committee, which is an advisory committee to the Military Airlift Command, that a leasing arrangement might conceivably make this more attractive to the airlines. However, the economic analysis relating to this program is not complete.

Similarly, we are conducting an economic analysis to determine whether a tanker transport bomber training aircraft for the Air Training Command should be acquired under a lease arrangement.

We do have procurement funds for this program in the President's budget, but we thought that perhaps we ought to also look at leasing as an alternative.

I would like to address a few of the procedural questions. One of your questions had to do with the availability of guidance from the Office of Management and Budget. In this regard we have found only one circular which seems to have some usefulness and, strictly speaking, it only applies to the lease or purchase of real property.

However, in the absence of other policy guidance, we have reviewed this circular, A–104, and are taking an approach which is generally consistent with that circular, which, however, does not require the consideration of tax effects, and we are adding that in these two economic analyses.

With respect to these two programs under consideration, we are considering the impact the tax incentives and leasing arrangements would have on the total cost to the Government.

The exact tax implications are difficult to quantify. We have found in the last week, in discussing the matter with the Treasury Department in preparation for these hearings, that we have some basic misunderstandings, or disagreements, or differences of opinion, as regards how these tax implications should be calculated, and, needless to say, we will calculate them in accordance with the guidance we receive from Treasury.

Our analyses relating to both the civil reserve air fleet enhancement program and the tanker trainer bomber programs are ongoing and not yet complete. Our objective is to determine the present value of net tax consequences for consideration in determining the true cost of leasing to the Government.

We have not yet completed these assessments.

In comparing the administrative and congressional review approval process for a large number of aircraft, we have found with respect to the two lease programs with which we have now had some experience, that is, the C-140 and the T-39, that there has not been much difference.

We have had to obtain support both from the authorization and appropriations committees, and have had to obtain explicit case-related lease authority in legislation.

Although leasing may offer savings in total costs to the Government, and we may recommend it as a procurement strategy in certain future programs, we are fully aware that enabling congressional legislation is required on a case-by-case basis before we can implement any long-term leasing programs, since the statutory authority permits leasing for only 1 year.

All procurement programs, no matter how structured, will be approved and have been approved by the Air Force, the Office of the Secretary of Defense, Office of Management and Budget, in terms of our internal review and programing process.

In summary, let me just say that we do not see leasing as a major component of our major systems acquisitions program. Until recently leasing has not been an attractive alternative to the traditional acquisition process.

It now appears that leasing may be a viable alternative in certain systems acquisitions, particularly where the system is commercially available off the shelf with residual commercial value.

Very few of our programs have this characteristic. We believe that leasing should be considered on a case-by-case basis only when justified as being in the best interests of the Government, either by appropriate mission impact or by cost benefit analysis which would include consideration of the net cost to the Government.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF LLOYD K. MOSEMANN, DEPUTY ASSISTANT SECRETARY, LOGISTICS AND COMMUNICATIONS, DEPARTMENT OF THE AIR FORCE

Good afternoon, I am Lloyd Mosemann, Deputy Assistant Secretary of the Air Force for Logistics and Communications.

Mr. Chairman, we appreciate the opportunity to provide the Committee with background information concerning Air Force long-term leasing of high-cost property.

The Air Force really has had virtually no such lease arrangements. We have leased automated data processing equipment (ADPE), vehicles, and some family housing; the latter primarily in overseas areas. With these exceptions, which it is my understanding the Committee does not plan to address in these hearings, we have had no long-term leases for major equipment. Frankly, until recently, it has been our belief that it is cheaper to buy and own rather than to lease. Even with respect to Automated Data Processing equipment, we are more and more either buying the equipment outright or are leasing for a short period after which we exercise an option to purchase. However, we are now considering several lease programs. In our two approved programs, we concluded that lease is the most respon-

sive means by which to satisfy some rather unique, or atypical, Air Force mission requirements.

I will discuss two lease projects which we are currently pursuing with Congressional authorization, briefly describe two areas we are investigating as lease candidates, and then address the specific conceptual questions which were provided to us prior to the hearing. I am prepared to respond further to the provided questions during our discussions. The two lease projects which we are currently pursuing involve the C-140B and CT-39 replacement aircraft programs.

Specifically, we have a program to obtain three aircraft on a short term lease arrangement of one to two years for use in the 89th Military Airlift Wing, what we call the Special Air Mission (SAM) fleet located at Andrews Air Force Base. We also have authority to proceed with a second program to lease 120 aircraft as replacements for the CT-39 aircraft.

Congress has advised us for the past two years to acquire replacements for the aging, range- and payload-limited C-140B aircraft currently operated by the 89th Military Airlift Wing at Andrews AFB and Ramstein AB Germany. The requirement is for a fuel efficient aircraft capable of carrying at least 14 passengers over transcontinental ranges. We recognize that replacement is long overdue, and are pursuing that acquisition through normal procurement channels. There are commercially available off-the-shelf aircraft that satisfy the requirement. However, we have found that they can be obtained one year sooner by leasing the first three of eleven aircraft at a cost within current budget constraints. Our acquisition strategy of a short-term lease followed by purchase in FY 85 provides the greatest capability in the shortest time, and is consistent with Congressional direction. We are currently conducting a competitive source selection to identify the best aircraft for the mission.

We also have explicit Congressional authority to proceed with a second program to lease 120 aircraft as replacements for the CT-39 operational support aircraft. In the Continuing Resolution Authority there is text tying the CT-39 replacement to another program for European distribution system (EDS) aircraft. However, the two programs are, in fact, separate and distinct, and require aircraft of distinctly different capability. We plan to procure the EDS aircraft in the traditional acquisition manner, and I will not address it further here.

The CT-39 replacement program is aimed at replacing 22 year old six passenger Sabreliners with an equivalent off-the-shelf executive jet. The total requirement is for 120 operational support aircraft. Operational support aircraft have an amalgam of time sensitive wartime contingency missions including command and staff movements, medical and security personnel, and intelligence support. In peacetime they provide low cost flying experience for recent graduates of pilot training. (We currently have 136 CT-39s, most of which are used in various operational support roles, but also include two for checking navigation aids, ten for various experimental and research purposes, and four in the Air National Guard. Our present plan is to keep the latter sixteen.)

The existing CT-39 airplane, because it is old, has numerous problems. In the last ten years we have had three major structural refurbishment programs, and the end is not in sight. If we keep the airplanes in service, we are faced with an estimated $120 million bill for accomplishing major wing reskinning, corrosion control and minor structural repairs within the next five years. In addition, because the aircraft is so old, it is fuel inefficient.

We have discussed replacement of the CT-39s almost every year for the past five years; however, in a military environment already short of combat arms, the CT-39 replacement has not successfully competed with higher priority requirements.

Our thinking, however, changed dramatically last summer when we received an unsolicited proposal from the manufacturer of a small business jet of the type that could be an off-the-shelf replacement for the CT-39. This proposal contained some interesting facts and figures; namely, that we could lease new aircraft, obtain contractor maintenance of those aircraft, and operate the aircraft within the same level of funding that we are spending today for maintenance and operation of the CT-39 fleet.

As we studied the proposal, three things became obvious:

1. The proposal was fiscally attractive. Its attractiveness derived in some measure from the depressed condition of the aircraft manufacturing industry, which permitted the contractor to give us a rock bottom price for the new aircraft—hence a "window of opportunity" exists for at least a short period.

2. It would not be appropriate to award a sole source contract on the basis of the unsolicited proposal, as there are other equally capable off-the-shelf aircraft that could be used to replace the CT-39.

3. We needed explicit Congressional authorization to enter into a long term lease contract.

We rejected the unsolicited proposal, but requested Congressional authority to enter into the lease arrangement. This was granted in the Continuing Resolution Authority. Additional funds were not requested, because the lease arrangement will cost us no more than the operation and maintenance of the existing CT-39 aircraft.

Our present schedule provides for a competitive request for proposals to be issued in late March 1983, providing for aircraft deliveries at the rate of four to eight per month beginning one year later. The terms of the lease will be for five years (with an additional three years optional). The Air Force is considering several alternatives regarding possible later purchase of the aircraft.

There are two other programs under discussion in the Air Force that could conceivably involve lease arrangements. For example, the Air Force is now conducting an independent analysis of leasing, including leveraged leasing, which was prompted by proposed alternative strategies to incentivize and fund the Civil Reserve Air Fleet (CRAF) Enhancement program, which involves the modification of airline-owned aircraft. However, this analysis is not yet complete. Similarly, we are conducting an economic analysis to determine whether a Tanker Transport Bomber (TTB) training aircraft for the Air Training Command should be acquired under a lease arrangement.

Now let me try to address some of your questions that seem to deal more specifically with the philosophy of leasing. As I mentioned, the Air Force has had little experience with this acquisition method. In our two approved programs, we were driven more by exigency and need than by cost trade-offs between buying and leasing. However, now that we have kind of backed onto the leasing business, we are beginning to address more directly the question of whether leasing is an acquisition approach that we should more frequently consider. We are, therefore, beginning to consider the philosophical and economic issues that, I believe, are the concern of this Committee. In this regard, we have found OMB Circular A-104 not totally useful, because, strictly speaking, it relates only to the lease or purchase of real property. However, in the absence of other policy guidance, we have reviewed Circular A-104 and are taking an approach which is generally consistent with that Circular.

With respect to CRAF and TTB, the two programs now under consideration for leasing, we are considering the impact that the tax incentives in a leasing arrangement would have on the total cost to the Government.

The question is how much of the tax losses can be directly attributed to these Air Force initiatives?

The exact tax implications are difficult to quantify. Compounding the difficulties in quantifying the tax implications to the government, expecially in the CRAF Enhancement Program, is the tax-loss position most of the US carriers are in today. Needless to say, our analyses related to both the CRAF and the TTB programs are on-going but not complete. Our objective is to determine the present value of net tax consequences for consideration in determining the true cost of leasing to the government. We have not, at this time, completed these assessments.

In comparing the administrative and Congressional review and approval process for a large number of aircraft, practically speaking, with respect to the two lease programs on which we now have had some experience, there hasn't been much difference.

Although leasing may offer savings in total costs to the government, and we may recommend it as a procurement strategy in certain future programs, we are fully aware that enabling Congressional legislation is required on a case by case basis before we can implement any long term leasing program since the existing statutory authority permits leasing for only one year. All procurement programs, no matter how structured, will be reviewed and approved by the Air Force, OSD, and OMB internal program and review processes, before going to Congress for final approval. However, to the extent that no additional funds are required, as in the case of the CT-39, specific line item appropriation is not required. The funds, of course, are reviewed at all levels as a part of the justification for the overall Appropriation for Operation and Maintenance. Therefore, our leasing experience does not indicate a divergence from the normal weapon system acquisition approved processes.

In summary, let me say again that we do not see leasing as a major component of our major systems acquisition programs. Until recently, leasing has not been an attractive alternative to the traditional acquisition process. But now it appears that leasing may be a viable alternative in certain systems acquisitions, particularly where the system is commercially available off-the-shelf. Very few of our programs have this characteristic. Further, we believe that leasing should be considered on a

case by case basis only when justified as being in the best interest of the government by appropriate mission impact and/or cost benefit analysis, which includes consideration of the net cost to the government.

Chairman RANGEL. Mr. Secretary, then it is your testimony, as you related to the CT-39 and C-140-B, that there was no consideration at all as to the tax expenditure; just a question of the direct Air Force lease costs. Is that correct?

Mr. MOSEMANN. Correct.

Chairman RANGEL. Also, one of the considerations in deciding to go the lease route was whether or not the Department of Defense had refused to budget that item, so what you could not get in the budget, you could possibly use this route in order to lease it for the Air Force. Is that correct?

Mr. MOSEMANN. With respect to the C-39, we never went to the Department of Defense to ask for funds. We, within the Air Force, concluded that you are right: seeking funds would not be a viable way to obtain replacement.

Chairman RANGEL. Well, let me compliment you, Mr. Secretary, for the candor in which you presented the problems faced by the Air Force, and also the fact that even though you did not have those guidelines in the past, that you have now embarked on some method to determine what those costs will be to the taxpayers in the future.

Mr. MOSEMANN. Yes, sir, that is our intention.

Chairman RANGEL. I assume that the Navy did not share their creative guidelines with you?

Mr. MOSEMANN. No, there are a number of significant differences between our approach and the Navy's approach.

Chairman RANGEL. Any questions for the panel?

Mr. PICKLE. Yes, Mr. Chairman.

Mr. Secretary, this is a policy question, and I raise it because it has been in the press lately.

On February 1 of this year, Energy Secretary Hodel testified that there was less need for involvement in the Mideast because of the glut of oil and the pressures being less now than they were 2 to 4 years ago. There was some indication that perhaps we would need less involvement in that area.

What is the situation now? Do you give just as much importance to maintaining this kind of strategic participation by these ships in the Mideast area?

Is the need just as great as before?

Mr. PYATT. Yes, sir, the advantage of those ships is that they can be moved to any location where the United States may desire to maintain a presence.

Mr. PICKLE. I understand there is some difference of opinion in the Defense Department that some question whether there is as great a need for this type of prepositioning ship as existed 1 or 2 years ago. Is that not correct? Is there some division within the Defense Department?

Mr. PYATT. No, sir. I don't know of any discussions that have gone on at the policy level.

Mr. PICKLE. Secretary Hodel, himself, said there is less strategic value to this type of participation than previously, and I noticed in

the paper some other Department of Defense people questioned whether we needed it as much as we did. I don't know.

Mr. PYATT. I don't know of any discussions along those lines.

Mr. PICKLE. Mr. Secretary, what has been the DOD's experience with respect to material prepositioning projects, specifically the Army's NATO POMCUS program.

This has been a subject of concern, due to high costs and apparent vulnerability to enemy action. Are these problems not expected to be experienced in the TAKX prepositioning measure?

Well, are the problems different? Are these ships open to an attack?

Mr. PYATT. Is that addressed to me or to Mr. Long?

Mr. PICKLE. I was asking the Department of Defense.

Mr. LONG. I will have to give you our view of POMCUS for the record. I cannot, off the top of my head, address that.

[Additional information was not received:]

Mr. PICKLE. The two projects are similar in nature, are they not? Why wouldn't the same concern exist for the prepositioning ship?

Mr. LONG. I think a way to answer that, Mr. Congressman, is that decisions have gone through the decisionmaking process within the Department of Defense, including its components, the military departments, and a determination has been made to preposition, to use these ships for certain purposes.

It is also fair to say that what the specific use at a particular time may be made of these ships will always be subject to examination and reexamination, and certainly in an institution the size of the Department of Defense, there will be differing views on many, many questions, but, right now, as I understand it, the position of the Department of Defense via the Secretary is that these ships will be used under—if the existing circumstances continue to obtain—the ships will be used in a particular way.

Mr. PICKLE. In a memorandum we have from Mr. C. R. Anderson, chief of the surveys and investigations staff, House Appropriations Committee, regarding these matters, he makes a statement that over the past decade the Army's NATO POMCUS has been the subject of concern to the committee due to its high cost and apparent vulnerability to enemy action. Problems evidenced in the NATO POMCUS program may be magnified in the MPS program because of the dangers to it.

There are similar concerns, are there not?

Mr. PYATT. Yes.

Mr. PICKLE. Mr. Secretary, without the investment tax credits and the need to structure the TAKX lease as a service contract, what are the reasons for staffing these ships with a civilian crew and giving up day-to-day control over operation, maintenance, and navigation of vessels designed for use in the event of the outbreak of hostilities?

Mr. LONG. Are you specifically addressing that question to me? That is really a question the Navy should answer.

Mr. PICKLE. Navy?

Mr. PYATT. We believe the merchant marine can do the job quite admirably. There is no need to use a Navy crew on a ship like this.

It is a floating warehouse, and we are currently doing it with the other ships.

Mr. PICKLE. Do you have control of the ships?

Mr. PYATT. Yes.

Mr. PICKLE. Navy has control of the ships?

Mr. PYATT. We can direct the ships to go where they go. We do not operate the ships. We do not have the control that the master of the ship has, if that was your question; but we can direct the ships when they go someplace.

Mr. PICKLE. I am going to read you another little document here in 1 minute. In the actual time charter contract, article 35 of the lease says "Nothing herein contained shall be construed as creating a demise of the vessel to the charter. The contractor shall at all times retain complete and exclusive possession and control of the vessel and its navigation," where it can go, in which direction it can go.

You would almost abandon ship, based on that provision of the contract, is that correct?

Mr. PYATT. We control where and when it delivers its cargo. We do not control the navigation in between.

Mr. PICKLE. It does not say anything about cargo. I am reading specifically from your charter. It says that the contractor shall at all times retain complete possession and control of its navigation.

Mr. PYATT. The master of the ship is in charge of its safety and security at sea.

Mr. PICKLE. If the Navy has given up the control of this vessel—and, as I said to you, Mr. Secretary, they have entered into this procedure because they want the tax advantages to be gained, that is the only way to get the vessel probably at this time—if that is the case, aren't we allowing tax policy to dictate a military policy?

The answer seems to be yes; we would not have this problem if——

Mr. PYATT. We have control of where and when the ship goes to a place.

Mr. PICKLE. You said it is a kind of qualified control.

If you control, it is no lease arrangement and this whole thing goes to deep 6. I had 3½ wonderful years in the Navy, and I am not trying to attack the Navy, but we have to bring out some of these questions.

My question is about control.

Mr. PYATT. There is another paragraph that I will read:

> The Contractor shall operate the Vessel in such services as the Charterer by written or telegraphic order may direct, including all matters relating to voyage and cargoes. The Contractor, through his agents, employees and servants shall commence and prosecute the voyages made pursuant to the Charter with utmost dispatch and shall render all customary assistance with the Vessel's crew and boats. In instances of urgency, orders or changes thereto shall be delivered via telephone and confirmed by letter or telegraphic dispatch. The Contractor shall authorize the master of the Vessel in the Contractor's behalf, to receive and carry out orders, directions or instructions as regards employment of the Vessel and prosecution of voyages, which may be issued by the Charterer.

Mr. PICKLE. Has this type of leasing—ships manned with U.S. personnel and with a surge force of 100 men, as in the case of the cargo ships—has this been done before in a deal of this size?

Mr. PYATT. There are 17 ships out there, and they also have some surge forces on them, very similar in nature.

Mr. PICKLE. You said this has been done before. You said earlier the shipbuilder got the ITC and accelerated depreciation cost?

Mr. PYATT. I said I was not familiar with exactly how those financial arrangements were.

Mr. PICKLE. Regarding wartime implications, specifically, what day-to-day control can the Navy exercise with respect to the operation and navigation of these vessels? What about the supervision of the crew? Do you control all that?

Mr. PYATT. The crew related to running the ship?

Mr. PICKLE. The crew?

Mr. PYATT. We do not control that.

Mr. PICKLE. The direction of the vessel, and so forth.

Mr. PYATT. I go back to the paragraph I just read about what they have to do.

Mr. PICKLE. You are going back to your statement. Of course, you can go back to it or make any statement you want to but I want to know who really controls this ship? And, depending on how you look at it under the circumstances, who controls it in the case of hostility?

Mr. PYATT. We do. We control where it goes, and they are bound to do that. We control it in peacetime, too, to the same degree I just read.

Mr. PICKLE. One other question with respect to the Department of Defense, when you have to establish the cost—and the Air Force also testified that you looked at the cost of the CT-39's, and you came to the conclusion it did not cost you any more—you said it did not cost us; by us, you mean the Air Force in this case, not the USA?

You are talking about the Air Force?

Mr. MOSEMANN. That is correct in the case of the CT-39. We have a very large savings, on the order of $100 million to $150 million, that will accrue regardless of whether you lease or procure.

Now, as these hearings have intimated, there probably will be some additional cost by leasing, as opposed to procuring.

We are in the process of determining what that is.

Mr. PICKLE. In one part of your statement said you could not enter into leasing because the Air Force could not control an aircraft as such, and so you ruled against that aspect.

I guess I come back to the same part of that, if you, the Navy, controlled those vessels—even in the manner in which you kind of eggshelled around—if the Navy controlled it, then all these other people participating in this program lose their investment tax credit. Is that correct?

Mr. LONG. If I may, the notion of control has various aspects, and what Mr. Pyatt and your dialog evidences is that there is the day-to-day control on how you navigate the ship and who operates it and the control over destination and where to pick cargoes up, and none of us at this panel are tax experts sufficient to determine what the measure of control on either of those aspects is and whether it is sufficient to destroy or support the investment tax credit.

Mr. PICKLE. The facts will have to speak for themselves.

That is why the IRS have not made their ruling yet.

Did you go to the IRS, Mr. Pyatt, to ask them for a ruling on this question before you entered the RFP, or before you entered into contract?

Mr. PYATT. It was our understanding the IRS would not issue a ruling in advance, and we did not go——

Currently, it is not our responsibility.

Mr. PICKLE. The point is, you did not go to the IRS, and so, therefore, the question is it still just dangles, doesn't it?

Mr. PYATT. Yes.

Mr. PICKLE. I will have a lot of questions for the Navy, but let me yield to any other member.

Chairman RANGEL. Mr. Dorgan?

Mr. DORGAN. Thank you, Mr. Chairman.

I would like to ask the Secretary, would you agree that the lease costs on this particular project would be higher than is currently envisioned in the absence of the investment tax credits or ACRS deductions?

Mr. LONG. Is your question, would the lease costs be higher under a given transaction without these tax benefits versus with? I think the answer to that is yes.

Mr. DORGAN. That being true, then the tax benefits represent part of the financing of the acquisition.

Mr. LONG. I think that is true—that is what brings about the whole notion of leveraged lease.

Mr. DORGAN. Except the consulting report that you have, I assume, which you made at least part of your decision upon, suggests that tax revenue losses should not be counted as part of the costs of the charter program?

Mr. LONG. You talked about the tax benefits flowing into the costs of the transactions. That talks about tax revenue loss to the Treasury, and those are two different tax considerations.

Mr. DORGAN. How can they be two different considerations? Isn't the tax break to the recipient exactly the same as the tax loss to the Government?

Mr. LONG. From the standpoint of the Navy or the Air Force, as a buyer, in negotiating a price, and you may have stepped out of the room when this was discussed, a portion of the tax benefits flows back to the Navy in terms of the price that is negotiated.

The rest, and I forget what the percentage was, based on the joint tax analysis, 66/34, something like that, the rest flows to the participants on the other side of the transaction and to that extent it does provide financing.

Now, the other side of the transaction, which is pertinent in this instance, perhaps because the Government is the buyer, is an additional item, but up until you consider the Government as a buyer, then the transaction is a purely commercial transaction.

Mr. DORGAN. The language is not perhaps because the Government is a buyer; it says especially because the Government is a buyer.

Mr. LONG. I fully understand that, but you talked about Government financing, and now you are talking about the tax revenue loss, and that is a different analysis.

Mr. DORGAN. Implicit in my question is the question to you, when the Defense Department decides whether to lease or buy

something, is it not appropriate to consider all of the costs to the Government?

Mr. LONG. Yes.

Mr. DORGAN. Your answer is yes, except with respect to one consulting study that you paid for, which says perhaps we don't have to consider the tax loss.

Did you rely on this? This advice suggests that perhaps the tax losses should not be counted as part of the charter program?

Mr. LONG. It is a report that we read, and we understood.

There are different methodologies in the Office of the Secretary. The methodology employed did take into account tax considerations on the revenue side as well as the expenditure side.

I cannot tell you that it equated precisely to the methodology on tax matters that the Joint Tax Committee used, because we only received the report on Saturday.

Mr. DORGAN. Except that I think you are wrapping this issue in the term of methodologies, and I don't think there is serious question about which methodology to use when analyzing the total cost of the lease decision. The GAO has testified, the Joint Tax Committee has testified. The Cooper-Lybrand study, incidentally, in its appendix, describes the differences in total costs. And the Cooper-Lybrand study, which you paid for, suggests that we ought not look at the revenue losses to Government. Now, you don't necessarily share that suggestion.

The study, itself, does say—in exhibit B—that if you assume the revenue losses as part of the costs, then, in fact, the decision made in this particular contract will cost the taxpayers more money than if the Government had purchased those ships?

I think that we have explored that issue long enough. I would like to ask a question about one more area that Mr. Pickle was asking about.

The issue is control. The control issue is important. As the Secretary knows, if the Navy has absolute control over the ships, the investors will not get the ITC tax breaks. Since that represents part of the financing structure, it means greater liability for the Navy in this case. Now, the brochure on these ships talks about support for the rapid deployment force, and the Secretary very carefully talked about the fact that the Navy may not necessarily have navigational control here; that it certainly——

Mr. LONG. What?

Mr. DORGAN [continuing]. May not have the opportunity to describe exactly how the ship is navigated from point A to point B, but they have the responsibility and the opportunity to say here is the way we want this ship to proceed. We want the ship to load something at point A and delivered at point B on Thursday.

That is what I assume your testimony to be. Is that correct?

Mr. PYATT. Yes, sir.

Mr. DORGAN. Since we are talking about support to a rapid deployment force, which by definition means that you are talking about an emergency, a forward action, are you comfortable with the lack of control on navigation and those kinds of things?

I sensed you were tiptoeing around it, and my guess is there are IRS people here listening very carefully to your answer.

Mr. PYATT. I am not tiptoeing around it.

I am saying that the control over the ships as currently exercised, that the ships that are now deployed for the Navy's purpose, is adequate.

We do not control the day-to-day operations of those ships, nor is it necessary in the TAKX.

Mr. DORGAN. Ship support represents that force that is going to get there quickly with striking power.

Mr. PYATT. These are not combatants, not amphibious assault ships.

Mr. DORGAN. I understand. The brochure describes sealift support for the rapid deployment force, stationed at forward bases to provide immediate support for the rapid deployment force, whenever an action may occur.

I wonder whether you are comfortable with the condition wherein you have made decisions about whether this ship is operated by the Navy with Navy personnel or privately chartered based on tax considerations.

Mr. PYATT. There is no need for them to be manned by Navy personnel. They are not combatants. We have, as I said before, 17 ships operating in the same manner that we are entirely satisfied with.

Mr. DORGAN. Well, let me reiterate something you have said, and that is that this particular issue is a broader issue that really needs to relate to a question of who makes decisions on these issues, and how do we analyze costs in lease-purchase decisions.

Chairman RANGEL. Mr. Secretary, you could furnish the committee with that, can't you?

Mr. PYATT. I am sorry. I will be glad to furnish the committee, when we get the question.

Mr. DORGAN. Well, this is a specific kind of situation, the Navy acquisition of prepositioning ships, but I think the committee in Congress is interested in the broader concept here. Who makes decisions on whether to buy or lease and under what conditions are those decisions made? I hope we get all the information.

[The information follows:]

HOW BUY OR LEASE DECISIONS ARE MADE

As previously discussed, decisions to lease or buy are made on a case-by-case basis and take into consideration financial or other aspects. Acquisitions are proposed by organizational elements of the Military Departments. These proposals are reviewed in the planning, programming, and budgeting system (PPBS). Reviews take place within the Military Departments, in the Office of the Secretary of Defense at OMB, and in the congressional oversight committees. Whether a particular acquisition is reviewed separately or as a part of a larger aggregate is normally dependent upon the dollar value of the transaction. In the case of the ships we have been discussing, the Senate and House Armed Services and Appropriations Committees had to be notified 30 days before any contract was awarded.—OSD.

Chairman RANGEL. You are caught between a rock and a hard place. If you have complete control over the ship, you lose your tax benefit, and if we don't have control, we lose our defense benefit; so, if you don't pay these employees on the ship, right?

Mr. PYATT. The contractor pays them.

Chairman RANGEL. So, if you have a contract dispute and the President sends the ship out, you have to send it to mediation, or something?

Mr. PYATT. What?

Chairman RANGEL. To determine who is right and who is wrong?

Mr. PYATT. The U.S. merchant marine takes great pride in saying they go where they are told to go.

Chairman RANGEL. I see. They don't go where the Navy tells them to go?

Mr. PYATT. When they are under contract to the Navy, they do.

Chairman RANGEL. You can't court-martial them; you just depend on the relationship you have with the contractor?

Mr. PYATT. The U.S. merchant marine and the personnel involved, have been quite satisfactory for a good period of time.

Chairman RANGEL. Mr. Pease, do you have any questions?

Mr. PEASE. Yes, Mr. Chairman, I do.

I would like to begin by asking Mr. Long, Secretary Long, whether there is an acceleration in the use of the build-and-charter arrangement?

Mr. Pyatt testified that since 1952, 30 ships have been subject to the build-and-charter arrangement, and in the last 6 months you put 15 under the build-and-charter arrangement.

Mr. LONG. Without having the data, and I will get this for you for the record, we really have two programs that happen to be 15 or 17 ships.

[Additional information follows:]

ITEMS IN THE BUILD AND CHARTER PROGRAM

The services the Navy is now acquiring involve 13 TAKX prepositioning ships, two T-5 tankers, and options for three additional T-5 tankers.—OSD.

Mr. LONG. Those two programs' worth of ships are doing some of the same things that some of those older ships from the earlier eras were doing, and they are being replaced.

So, we are not seeing, in terms of what is being sought to be accomplished by this, we are not seeing a marked increase in acceleration of this kind of acquisition strategy. It is something that has been used for this kind of ship in the past, and the ships which are subject to these two programs are replacing some of the earlier ships.

Mr. PEASE. What would you anticipate over the next 10 years would be your record? How many more of these would you expect to use?

Mr. LONG. One second.

The 5-year defense programs that are of this type—I can't take it 10 years out. I just don't have the data on our extended planning annex. There is none in the next 5-year program that I am aware of.

Mr. PEASE. You have testified that it was a close call on whether this was a good deal for the Government or not, taking into account the loss to the Treasury as well as the lower price; right?

Mr. LONG. On the financial—and I think that our records, which we will provide, or our analysis, which we will provide for you, will show on our analysis it was less than the 12 percent.

It was a very close call and for reasons relating to some of the things that I mentioned earlier, we determined to proceed along the course the Navy was desirous of proceeding along.

Mr. PEASE. Could I ask Mr. Pyatt why the Navy consultant did not pick up some of the errors in analyzing the tax considerations that the Joint Committee did, double-counting of income tax?

Mr. PYATT. I do not believe they made any errors.

Mr. LONG. Were those not in connection with a particular analysis?

Mr. PEASE. Yes, they were.

Mr. LONG. It was not a Navy analysis.

Mr. PEASE. It was Navy contract analysis.

Mr. PYATT. We sponsored the analysis in terms of providing the review for the House Appropriations Committee surveys and investigations staff, provided for review of your people, provided for review of our oversight committees. Part of the issue here is what is the appropriate model to use to evaluate these kinds of situations, and I will only say it was the first conscientious attempt I had ever seen taken at making an evaluation. It survived review for 6 months before anyone offered an alternative.

Mr. PEASE. Did anyone else have a chance to look at it during that period of time?

Mr. PYATT. It had been all over town.

Mr. PEASE. Who has been all over town?

Mr. PYATT. The report.

Mr. PEASE. I have been trying to get it for the last 5 months. I have been unable to get it.

Mr. PYATT. You did not ask me. You did not ask anybody I know of in the Navy.

Mr. PEASE. Secretary Long, you have said that it is a close call. We are agreed on that. You are under obligation now to fulfill this contract with these lessors, or providers of the service, or whatever. What if the tax benefits were not to be allowed by IRS? You would still be obligated to make the lessor whole, right? You would have to replace that lost revenue?

Mr. LONG. That is my understanding. We of course would have the option to terminate the contract, which the Government always has, for convenience.

Mr. PEASE. Would that significantly change the equation as far as the benefits to the Government?

Mr. LONG. I think it would change the equation on both sides. One of the things that is being discussed here is the loss of tax revenue by reason of these tax credits. Well, if there are not the tax credits, you do not have the loss on the revenue side, although you may have an increase on the DOD side.

Mr. PEASE. Mr. Pyatt, I am particularly interested as you well know in the contract for the 5 tankers. A consultant named Argent, is that right, did your work?

Mr. PYATT. Yes, sir.

Mr. PEASE. Was there any other consultant who did any work on this particular project prior to Argent?

Mr. PYATT. On the T-5 as a specific? No. The Coopers-Lybrand study was a nominal study of ships. It was not particularly oriented toward a particular project.

Mr. PEASE. I had heard that you had another consultant dealing specifically with the T-5 that was not satisfied with the results. Is that not correct?

Mr. PYATT. I do not know of anyone.

Mr. PEASE. Can you tell me a little bit about how Argent got this contract?

Mr. PYATT. The Navy advertised in the Commerce Business Daily and Argent, among others, applied in the competition and were selected by virtue of their past experience and financing.

Mr. PEASE. They have done other work for the Navy?

Mr. PYATT. Not for the Navy. In the commercial sector.

Mr. PEASE. Were there other bidders besides Argent, do you happen to recall?

Mr. PYATT. Yes, there were.

Mr. PEASE. Is this done on a competitive basis, pricewise, or how do you do that?

Mr. PYATT. The competition as advertised was based on price and experience of the people involved.

Mr. PEASE. What if we would have to reimburse the lessor for expenses for loss of tax credits or something of that sort? Where would the money come from? Is that from the operations and maintenance account, also?

Mr. PYATT. The charter fee would be raised. That would come from the O&M account. It would come from the industrial fund rates that are being charged. But I would like to point out, in the case of the T-5, by virtue of getting new, modern ships, we expect the price, including the capital hire, to be the same as the old 25-year-old inefficient ships. So it makes very little difference.

Mr. PICKLE. Would the gentleman yield?

Mr. PEASE. I would be happy to.

Mr. PICKLE. I would like a little more specific question with respect to the TAKX. What happens if the IRS rules this is not a service lease?

Mr. PYATT. If the IRS rules this is not a service lease, I missed the next couple words.

Mr. PICKLE. What would it cost the Navy if the IRS so ruled? Where would the Navy get the money?

Mr. PYATT. We would have to budget it in future appropriations. I will provide the number for the record.

[The information follows:]

INVESTMENT TAX CREDIT

It is intended that the Owners will request and obtain an IRS ruling on the Investment Tax Credit (ITC) issue prior to delivery of the ships and commencement of the Time Charter. If the IRS rules that the ITC is not available for these ships the Navy's charter hire schedule will be revised and the additional costs financed and spread over the 20 or 25 year charter period. The cost impact on the Navy and total Government in the event the ITC is not available was shown on the Argent Group Reports for both the T-5 tankers and TAKX ships which was submitted to the Congressional Oversight Committees in August/September 1982. In the case of the T-5 tankers the Navy's average charter hire would increase by $820,000 per year at a total present value increase of $6.56 million per ship. However the present value savings to the total Government increases by $1.24 million due to the favorable impact on the Treasury if the ITC is not available.

In the case of the TAKX ships the average additional charter hire cost to the Navy would be $2.8 million per year per ship for a total present value increase of $23.6 million. However, the net impact on the Government as a whole is an increased savings in present value of $3.84 million per ship.—Navy.

Mr. PICKLE. We heard earlier, I understand $2.3 billion, at least that much. You say you would have to budget it in future budgets. What happens immediately?

Mr. PYATT. The Navy makes no payments on this program until it receives services.

Mr. PICKLE. Everything would just stop?

Mr. PYATT. No.

Mr. PICKLE. That seems rather abrupt, awkward.

Mr. PYATT. If the charter rate increases in the future, the Navy has to budget more money to pay for that increased charter rate. It will not terminate the program.

Mr. PICKLE. I will yield back, Mr. Pease. But we had heard earlier that you finance these things through the NIF, perhaps through O/M accounts. And if the contract is terminated it is a very large amount of money. You are saying if that were to happen, the Navy would not just fork over $2.3 billion, but would say to the Congress we need $2.3 billion to go ahead with the program. We will ask you for it in future budgets—is that what you are saying?

Mr. PYATT. No, no. There are two separate issues, I believe. One, if the program is terminated for any reason, how would that be paid for?

Mr. PICKLE. Yes.

Mr. PYATT. Currently the obligations accruing from this contract are secured by the unobligated balance of the Navy industrial fund. We would either take it from that fund, and defer something else with the approval of Congress in a reprograming action, or we would seek additional appropriations.

In the other case that you were describing, if by some aspect of an IRS ruling the rental rate for the ship has to increase, we would have to get that money through future appropriations like we get our other charter money for other ships. The rent would go on.

Chairman RANGEL. If the gentleman would yield further.

Mr. PEASE. I would be happy to yield to the chairman.

Chairman RANGEL. I think Mr. Pickle is saying that, if the IRS rules that it is not the type of contract which the Navy has assumed, how much additional fiscal financial responsibility will the Navy have?

Mr. PYATT. We will have to calculate that and put it in the record.

[See answer above.]

Mr. PICKLE. You know pretty much what that is, do you not? You know you have to pay 10 percent of the ITC. You know you would have to pay $235 million; would you not?

Mr. PYATT. Yes. That is over time. That runs about $2 million a ship a year.

Mr. PICKLE. The contract says that amount of money has to be paid back within 20 days; is that not correct?

Mr. PYATT. But we intend to get a ruling before——

Mr. PICKLE. That is not my question. The question is, you know you have to pay that much back immediately.

Mr. PYATT. That is right.

Mr. PICKLE. So you do not have to be vague. You know that much is going to be your cost; do you not?

Mr. PYATT. But I am also saying we would know that before we entered into the long-term financing when that particular clause comes to play.

Chairman RANGEL. Why is it that you would not want Treasury to give you some advice as to whether it is a service contract before you got as far as you did go?

Mr. PYATT. It was our understanding, it still is, that the Treasury will not rule on a particular arrangement absent the complete set of facts.

Chairman RANGEL. Are you saying that one Federal agency cannot get an understanding with another Federal agency as it relates to what is a contract? What made you think you could not get an understanding from Treasury on this matter? Did you request one?

Mr. PYATT. No, we did not request one. People in OSD who were looking at it came to that conclusion.

Chairman RANGEL. Without the benefit of Treasury——

Mr. PYATT. I am sure they talked with Treasury.

Mr. PICKLE. Well, I understood, Mr. Chairman, that the Navy did make inquiry with an insurance company to see if they would insure the Navy as against possible loss of these credits in the event IRS gave an unfavorable ruling; is that correct?

Mr. PYATT. I am not aware of that.

Mr. PICKLE. I am told you went to Lloyds of London and that after they looked at it closely they said they would not want to touch it with a 10-foot pole. Is that not true?

Mr. PYATT. The contractor may have, but the Navy did not.

Mr. PICKLE. We will pursue that.

Mr. PYATT. Yes, sir. If there is additional information on that point, I will provide it for the record. But I am not aware of it.

Mr. PEASE. Mr. Chairman, before I forget, I would like to ask the Chair's permission to submit additional questions to the witnesses for replies for the record.

Chairman RANGEL. Without objection.

Mr. LONG. Mr. Chairman.

Chairman RANGEL. Yes, Mr. Secretary.

Mr. LONG. I am backed up against——

Chairman RANGEL. We fully appreciate the time you have given to us.

Mr. LONG. May I be excused?

Chairman RANGEL. Definitely.

Mr. PEASE. Mr. Pyatt, the contracts between lessors and Navy for the TAKX and the 5 tankers, are they public information?

Mr. PYATT. Yes, part of them are public information, part of them are what is called business sensitive and are not public information.

Mr. PEASE. Would the same be true if you had a direct procurement?

Mr. PYATT. Yes.

Mr. PEASE. Under what circumstances can I get access to those parts of the contract which are open to the public?

Mr. PYATT. Ask.

Mr. PEASE. I have been asking for 4 months.

Mr. PYATT. There are no contracts on the T-5.

Mr. PEASE. They have not been signed yet?

Mr. PYATT. The only thing that has been signed has been in the acceptance of the Navy of their proposal.

Mr. PEASE. When will the contracts be signed?

Mr. PYATT. Contracts are firming up—the same kind of contract that was reviewed by the staff—I would guess would be available within 2 months.

Mr. PEASE. Would the proposal from the companies be public information?

Mr. PYATT. Usually not. In fact, never, as far as I can recall.

Mr. PEASE. Is it not a little hard for the Congress to conduct oversight if there is no access to the proposals, or to the contracts, either one?

Mr. PYATT. I cannot recall any situation of the Congress having asked for proposals.

Mr. PEASE. So if this committee asked for proposals, you could give us copies of those?

Mr. PYATT. If the committee were to make such a request, I would have to refer the issue to our counsel and let them review it within the context of existing law and regulation.

Mr. PEASE. Mr. Pyatt, I think the chairman has just signaled me he is eager to get on with the next panel of witnesses. Let me just pursue one other line of questioning. That is on the oversight again. Normally I understand four committees in Congress sign off on these arrangements; is that correct?

Mr. PYATT. The law says the recommendation from the Secretary of the Navy shall rest for 30 days.

Mr. PEASE. How do you do that in practice, let it rest and then proceed, or do you get a letter from each of the chairmen?

Mr. PYATT. In practice normally you let it rest and proceed.

Mr. PEASE. Repeat that, please.

Mr. PYATT. In practice you normally let it rest and proceed. There are other situations like this where you have a waiting period.

Mr. PEASE. Thirty-day waiting period, it lapsed about November 1 last year. Why did you wait another 53 days, according to your testimony?

Mr. PYATT. Toward the end of that 30 days the staff of Senator Stevens said we have some questions, would you please answer them? We did. When it was clear that there were no other questions coming, we proceeded.

Mr. PEASE. Did Senator Stevens ever indicate that he was satisfied with the arrangement?

Mr. PYATT. I think Senator Stevens had a lot of things going at that time, and it just did not seem to be an issue that he was taking up.

Mr. PEASE. So you just decided unilaterally to go ahead without his approval; is that right?

Mr. PYATT. Yes, sir. We had fulfilled the requirements of the law.

Mr. PEASE. Does that not strike you as being somewhat less than complete oversight on the part of Congress? The question is——

Mr. PYATT. Within the law there was a certain period of time for them to take up the investigation and raise whatever issues they

wanted to. We proceeded to comply during that timeframe, and then did what we felt was appropriate.

Mr. PEASE. Do you think congressional oversight procedures are adequate in the leasing area?

Mr. PYATT. Yes.

Mr. PEASE. You would not recommend any changes?

Mr. PYATT. No.

Mr. PEASE. I see.

Mr. PYATT. I would say that our methods of evaluating lease versus buy and considering tax impacts are far from complete. But the oversight expressed by our committees is fine.

Mr. PEASE. Thank you.

Chairman RANGEL. Thank you. You did say 5 of these TAKX ships were converted from foreign ships?

Mr. PYATT. Yes, sir.

Chairman RANGEL. What is the difference in cost, do you know offhand, between a new ship and a conversion of a foreign ship? We buy these ships from a foreign government?

Mr. PYATT. We did not buy them. They would be leased from an American firm.

[Additional information follows:]

COSTS OF TAKX SHIPS

The five Maersk ships were foreign built and purchased by an American owner for conversion. The average capitalized cost per ship is $190 million. The five TAKX ships being newly constructed by General Dynamics will have an average capitalized cost of $175 million.—Navy.

Chairman RANGEL. There will be some other questions. You might include that in the other information that would be requested.

Mr. PYATT. Yes, sir.

Chairman RANGEL. We want to thank you for your appearance.

Mr. PICKLE. Mr. Chairman.

Chairman RANGEL. Of course.

Mr. PICKLE. Mr. Pyatt, in 1973 the GAO made an analysis of the Navy's decision to enter into the program. They said the Navy selected the build-and-charter program not as a result of a lease-versus-purchase analysis but because it could not obtain procurement funds to purchase new tankers, but would rather have a procurement fund for ships. This is not a hostile question, but is not this basically the same situation you were faced with when you made a decision to proceed with the TAKX?

Mr. PYATT. Except in this particular case the Congress was suggesting to the Navy that we should look into chartering these ships rather than buying them.

Mr. PICKLE. I do not know whether that is correct or not. I do know Admiral Carroll has stated that originally we planned to acquire these ships, but budget constraints required us to look at other alternatives. As a result, we are pursuing a convert-and-charter alternative. So the Navy is doing again what they said they did 10 years ago mainly because you want to use your funds for other purposes. That is essentially a factual situation you face; is that not correct?

Mr. PYATT. Not only the Navy, but the Congress. These services——

Mr. PICKLE. Air Force and others. That is a very legitimate position that you have to ask yourself, How do you proceed? But as you proceed, you have to think also in terms of the tax loss to the Treasury.

Mr. PYATT. Yes, sir.

Mr. PICKLE. Why did the Navy negotiate a 5-year contract, 4 consecutive years of renewal, 4 or 5 years?

Mr. PYATT. We felt that was the most appropriate way to proceed; in the event changes occurred in the future, it would allow change to be more easily implemented.

Mr. PICKLE. Why did you not issue a 25-year lease?

Mr. PYATT. Again, we thought 5-year increments were the most appropriate way to do it.

Mr. PICKLE. Well, in addition, you do not have the authority, do you, to enter into a 25-year lease, do you?

Mr. PYATT. I do not believe the authority is any different for a 5- or a 25-year lease.

Mr. PICKLE. When you go to comparing whether it is 5 or 25, there is no difference then?

Mr. PYATT. For purposes of analytic comparison, no, there is no difference.

Mr. PICKLE. You got a chance—suppose the Navy has the option to discontinue the arrangement at the end of any 5-year period. What would it cost?

Mr. PYATT. I will provide that, those termination schedules, for the record.

[The information follows:

TERMINATION VALUES

The following table contains the termination values, expressed in millions of dollars, for each of the vessels in the program at 5-year intervals over the 25-year period of the contracts.—]

TERMINATION VALUES AT END OF YEAR

	5	10	15	20	25
General Dynamics:					
1	$162.431	$145.697	$115.550	$66.267	0
2	158.957	142.574	113.079	64.866	0
3	154.507	138.587	109.926	63.059	0
4	151.153	135.578	107.540	61.675	0
5	160.674	144.122	114.301	65.551	0
Maersk:					
1	179.752	161.217	127.868	73.352	0
2	177.047	158.729	125.842	72.155	0
3	169.676	152.192	120.701	60.193	0
4	178.022	159.713	126.717	72.708	0
5	168.985	151.606	120.284	69.017	0
Waterman:					
1	154.504	138.519	109.819	62.968	0
2	153.316	137.531	109.104	62.579	0
3	153.268	137.475	109.029	62.502	0

Mr. PICKLE. It would cost pretty heavily, would it not?

Mr. PYATT. Yes.

Mr. PICKLE. All right. In constructing this lease agreement, the Navy has gone to the private sector for contractors, lessors, and equity owners. I want you to tell me, what risk do these equity owners have, and what do you expect their after-tax return to be? First, what risk do the equity owners have? Are they getting the ITC and ACRS, some residual value? What risk do they have?

Mr. PYATT. I think their risks are primarily financial, relating to the tax situations involved.

Mr. PICKLE. They have got the finance and they can put it up. Then there is no risk, is there, just none, period?

Mr. PYATT. None. The real risk——

Mr. PICKLE. What rate of return do they have?

Mr. PYATT. Eleven percent.

Mr. PICKLE. Plus residual value.

Mr. PYATT. That is right.

Mr. PICKLE. Fourteen percent. So they have got no risk, and they can get a 14-percent return. That is not a bad proposition, is it?

Mr. PYATT. Except the residual value in the staff report is vastly overstated.

Mr. PICKLE. What residual value will they have?

Mr. PYATT. In the constant dollars that they use to make their estimate, I think they are probably worth $1 or $2 million rather than $9 million.

Mr. PICKLE. There is a great difference there. The two agencies you commissioned to make the lease study, one said it had a zero value.

Mr. PYATT. That is right.

Mr. PICKLE. Another said the ship would have a $2 million value. The Joint Tax Committee as I recall said it might be worth as much as $8 million or $9 million. Now you say $1 million.

Mr. PYATT. I am saying in the current market for ships that old, $1 million or $2 million——

Mr. PICKLE. But if you stretched it out, it might be $8 million or $9 million?

Mr. PYATT. And bring it back to present value.

Mr. PICKLE. Who gets that value?

Mr. PYATT. The owner of the ship.

Mr. PICKLE. He gets the value?

Mr. PYATT. That is returned to him; yes.

Mr. PICKLE. Is that a lease, or is that a sale? If it was no value, it would be just a sale, would it not?

Mr. PYATT. It is a lease. He retains the ship, not the Navy.

Mr. PICKLE. But the value would go to the shipowner.

Mr. PYATT. Right.

Mr. PICKLE. And the Navy would have no interest, no control in it at all?

Mr. PYATT. That is right.

Mr. PICKLE. Suppose that the IRS were to rule that this was not a lease, but that it was going to be used exclusively by the Navy. Would that still deprive them of the use of the ITC? Would they not lose that?

Mr. PYATT. That is right, they would.

Mr. PICKLE. If the Navy were going to use it totally?

Mr. PYATT. As I understand the law, that is the case.

Mr. PICKLE. Well, it seems to me like--I am not trying to say any of these private companies have done anything illegal. They certainly have not. And the Congress has written these laws to provide for it. We cannot say there is anything that is wrong. If there is some value to it after it is over, the shipowner gets it. But if there is no value, then it is not a lease, it is a sale. Is that correct? Yes, that is correct.

Mr. PYATT. For our analytic assumptions we assumed it was zero value.

Mr. PICKLE. The question of whether it is a lease or sale gets to be very important, and it depends on who owns it.

Mr. PYATT. I am sure it would be worth something at the end of 25 years.

Mr. PICKLE. Well, yes. You said this is not a matter of concern to you. You have got 25 years to worry about it.

Mr. PYATT. It is not the top priority——

Chairman RANGEL. I do not think so. The question you're asking is one you should be deeply concerned with. That is how IRS is going to review your contract. Obviously you have not requested any ruling.

Mr. PYATT. That is right.

Chairman RANGEL. You would agree, just from a layman's point of view, that if there is no value at the conclusion of a lease, that you have a conditional sale.

Mr. PYATT. That is right.

Chairman RANGEL. I know you would agree. That balloons into a possible liability dependent on which way the IRS rules.

Mr. PYATT. That is right.

Chairman RANGEL. So when you say you do not have a concern, you or somebody should have a deep concern, because you do not even have the money in your budget for this type of ruling.

Mr. PICKLE. How do you square it—I am not going to belabor the point—but how do you square this residual value with the requirement by the Internal Revenue? They have a guideline that requires a residual value of at least 20 percent in order for a transaction to be considered a lease rather than a conditional sale. How do you square that? Did you know that was a requirement?

Mr. PYATT. Yes; I knew that was a requirement. I was looking at it in terms of the value of a 25-year-old ship in today's market.

Mr. PICKLE. Mr. Chairman, I have asked too many questions. I will not go on.

Chairman RANGEL. We want to thank you for the candor in which you presented your case before the Congress. Clearly, you did the best you could without guidelines. I hope the Congress would be a little more gracious in the future with your particular department. I want to thank you for your creativity and your innovative approach to the tax law. You did a good job for the Navy.

Mr. PYATT. Thank you very much.

[The following are answers to questions submitted to the Department of the Air Force:]

Air Force Answers to Questions on Federal Leasing Practices

Question 1. You indicated in your testimony that the Air Force has not considered the total costs to Government in making the decision to lease 120 CT-39 "Special Mission Aircraft" and 3C-104B "Executive Aircraft" but intends to look at resulting Federal revenue losses in the future.

(a) Is that correct?

Answer. That is correct. The Air Force intends to assess all costs associated with leases in future cases. Our two ongoing acquisitions are somewhat special cases. The C-140B is a short-term (12 to 18 months) lease for 3 airplanes as the front end of an 11 airplane procurement package. The CT-39 lease plan is intended to produce energy and manpower savings because new equipment can be leased, maintained and operated for less than the ongoing costs of maintaining and operating the existing CT-39 fleet.

(b) With regard to the tax impact of leasing CT-39's, you mentioned that the Air Force is "in the process of determining what it is." Please submit your analysis and conclusions for the record.

Answer. The tax impact of leasing CT-39's will be computed after we have reviewed our cost analysis methodology with the Treasury Department and have applied that methodology to proposals submitted in response to the CT-39 solicitation. We expect initial responses to the solicitations the latter part of May, 1983. It is not now known how soon these analyses will be available, but they will be provided when available.

(c) In future leasing decisions, what division of the Air Force will prepare lease versus purchase analyses?

Answer. The Cost Analysis Division, Directorate of Cost and Management Analysis, Comptroller of the Air Force will prepare the lease versus buy cost analysis at the Headquarters level. The sponsoring major commands will also prepare such analyses to support their requirements.

(d) What review or advisory function does DOD serve in relation to the Air Force's decision to lease rather than purchase aircraft?

Answer. The Office of the Secretary of Defense performs two functions with respect to lease versus buy decisions within the Air Force. First, the Director of Program Analysis and Evaluation is responsible for economic analysis policy and methodology. This serves as a guide to the Air Force in conducting these type of analyses. Second, the review process of the Planning, Programing and Budgeting System requires a complete review of each annual expenditure for all new systems. We believe that that review would serve to highlight the lease versus buy decision and determine if the Air Force should proceed.

Question 2. How many unsolicited proposals to lease aircraft has the Air Force received in the last year? Describe the range of possible leasing that the private industry has suggested.

Answer. The Air Force has received one unsolicited proposal for leasing aircraft in the last year. That was from Cessna for replacing the CT-39 force.

Question 3. Would you expect the Air Force's leasing contracts to be structured to insure any specific tax benefits for the lessor? If so, please discuss.

Answer. The Air Force has no plans to structure any lease specifically for a potential contractor to gain tax benefits; however, it is our understanding that accelerated depreciation is available to a lessor when the term of the lease is at least five years.

Question 4. It is the subcommittee's understanding that the aircraft to be leased in the four programs under consideration are noncombatant planes and therefore the type of aircraft that the Air Force considers appropriate to obtain through a lease.

(a) Is this correct?

Answer. By definition, the tanker-transport-bomber trainer is a noncombatant aircraft because of the training status. The other aircraft are noncombatant but will operate in a combat area.

(b) What type and what is the total number of aircraft that could be characterized as "noncombatant?"

Answer. Training aircraft, transport aircraft without a war-time mission (only the C-140s), and some utility aircraft are the only "noncombatant" aircraft operated by the Air Force. The only time the Air Force would lease an aircraft, except for unusual, small number or unique requirements would be when a commercial off the shelf aircraft would satisfy the requirements. In the foreseeable future, the TTB is the only aircraft being considered for lease in addition to the special case C-140 and T-39 replacement leases.

(c) Are there any other types of property that might be obtained, in the future, by lease?

Answer. In the past, the Air Force has leased computer equipment, office equipment, office space, and housing.

Question 5. Concerning the Air Force's statutory authority to enter into long-term leases,

(a) What types of leasing arrangements is the Air Force currently permitted to enter into?

Answer. The Air Force currently has statutory authority to enter into a long-term lease of the CT-39 replacement. The other system that the Air Force has statutory authority to proceed with is the C-140B replacement, however, that lease is for only one year to get the aircraft earlier than our planned buy. The C-140B replacement is basically a buy, not lease.

(b) What time restrictions (i.e., length of contract terms) apply?

Answer. The term of the CT-39 lease is limited to five years with up to one 3-option. The term of the lease is fixed by the statutory provisions contained in 10 U.S.C. Section 2306(g).

(c) Has the Air Force ever requested legislation to clarify its authority to enter into long-term leases? If so, please discuss.

Answer. The Air Force has not requested any across-the-board clarification legislation for leasing. The Air Force did request and receive specific lease authority for the CT-39 replacement program. That authority was provided in the Department of Defense Appropriation Act, 1983, Public Law 97-377.

Chairman RANGEL. We have one more panel, Department of Treasury. Hopefully, if you have some time we may get a ruling on some questions here. J. Gregory Ballentine, Deputy Assistant Secretary for Tax Analysis. From the Office of Management and Budget, Donald Sowle, Director of the Office of Federal Procurement Policy; and General Services Administration, Allan W. Beres, Associate Administrator for Acquisition Policy.

The full committee and subcommittee want to thank you for your patience and we will hear the testimony of all three witnesses. The testimony, if you wish to offer it, may be placed in the record in its totality. This will give you an opportunity to respond to questions the members of the committee have.

STATEMENT OF J. GREGORY BALLENTINE, DEPUTY ASSISTANT SECRETARY FOR TAX ANALYSIS, DEPARTMENT OF THE TREASURY, ACCOMPANIED BY ALAN WINSTON GRANWELL, INTERNATIONAL TAX COUNSEL AND DIRECTOR, OFFICE OF INTERNATIONAL TAX AFFAIRS

Mr. BALLENTINE. Mr. Chairman, I will submit my written comments for the record if it is appropriate and just summarize them right now.

Chairman RANGEL. Without objection.

Mr. BALLENTINE. A leveraged lease generally involves three parties: a lessor, lessee, and lender to the lessor. In the usual case a lessor will purchase the property to be leased, financing the acquisition by borrowing from a third-party lender.

The property is then leased to the lessee. The lessee's rental payments to the lessor, together with the expected residual value of the property at the end of the lease, plus the anticipated tax benefits of the property, are generally sufficient to discharge the lessor's payments to the lender, repay lessor's investment, and provide the lessor a reasonable return on the investment.

If the transaction is considered a true lease for Federal tax purposes, the lessor will be considered the owner of the property. In that event, the lessor will be entitled to claim the investment tax

credit and cost-recovery deductions. If the transaction fails to qualify, the lessee would be treated as owner of the property and the lessor would be viewed as merely financing the lessee's purchase of the property. In that case the lessor would not be entitled to a tax credit or cost-recovery deductions.

The determination of whether a given lease transaction is in fact a lease for Federal tax purposes or whether it is a conditional sale or other form of financing arrangement will depend on the facts of the particular case. There are no definitive criteria used for categorizing such transactions under current law.

I turn to a discussion of contracts that involve both a service agreement and a lease agreement. If the Navy enters into an agreement——

Chairman RANGEL. Mr. Secretary, using their lease agreement or whatever it is as a hypothetical, could you give an expert opinion as to whether or not it would be a valid service contract?

Mr. BALLENTINE. I anticipated that question. But no, we can't right now.

Chairman RANGEL. Hypothetical.

Mr. BALLENTINE. The difficulty with a hypothetical now is that this has gone much beyond the point of being a hypothetical. It involves known taxpayers. The IRS has not seen all the documents and cannot make a public statement about an arrangement such as this which has been very well publicized, including essentially all the parties involved and such. I know that is difficult in these circumstances, but it is a situation——

Chairman RANGEL. I apologize for the interruption.

Mr. BALLENTINE. In the typical lease, a lessor will transfer possession and control of the property to the lessee for the term of the lease and the lessee will be responsible for its day-to-day operation. Under a valid service agreement, the ultimate user of the property may be able to direct whether and where the property is to be used, but control, possession, and day-to-day operation of the property remain with the supplier of the service.

Whether an agreement is a service contract or lease is an inherently factual determination. To come to your question, Mr. Chairman, you have asked us to comment on whether the IRS would characterize the Navy Department's converted charter program for 1 of its 13 TAKX ships as a valid lease and service contract.

The transaction very simply is structured as a net lease of the ship by an investor partnership as lessor to an unrelated corporation as lessee. The lessee, in turn, will time charter the vessel to the Navy Department under a service contract called a time charter.

Although the IRS has reviewed the agreements relating to the Navy transaction that were supplied by the subcommittee, it would need more information before it could render its opinion on the validity of the lease, the bareboat charter, and service contract, and the time charter.

Chairman RANGEL. Then it is safe to say you treat the Department of the Navy as you would any other taxpayer?

Mr. BALLENTINE. I think it is fair to say we would treat this transaction the same as any other transaction.

Chairman RANGEL. Any request for information by the Department of Defense, Secretary of Navy, Air Force or Army, you would treat as you would a request from any other individual taxpayer?

Mr. BALLENTINE. Yes.

Chairman RANGEL. So, any opinions rendered by the IRS to these Government agencies would not be rendered until after the agency had actually signed a contractual agreement with the outside parties?

Mr. BALLENTINE. That is correct with respect to specific transactions. Even if the Service possessed all the relevant facts at this time, the Service could not express an opinion publicly on the transaction since it involves known taxpayers.

You have also asked us to comment on the tax indemnification provision included within the Time Charter Party Agreement.

In a typical lease arrangement, the rents charged are a function, among other factors, of the tax benefits attributable to the leased property that may be available to the lessor. In other words, the availability of the tax benefits on the leased property is an essential component of the lessor's return on the transaction.

If the transaction ultimately is found to be a mere financing transaction rather than a valid lease, any tax benefits will be available to the lessee rather than the lessor. It is not uncommon, therefore, for a lease agreement to provide that the lessee will indemnify the lessor against the loss of anticipated tax benefits.

In the Time Charter Party, the Navy Department has agreed to indemnify the ship's owner, under certain circumstances, for the loss of cost recovery deductions and the investment tax credit with respect to the ship.

Chairman RANGEL. Do you know of any other agreement like this where the U.S. Government is a party to this type of indemnity clause?

Mr. BALLENTINE. I don't personally know of one. I can't say that I would, had they been done, frankly. This provision appears to be consistent with the normal business practice of insuring that the benefit of the bargained for tax deductions and credits are available as anticipated by the parties.

I want to turn now to the emphasis on the role of financing costs and correct, consistent budget accounting for private capital formation incentives. The present value of tax deferred provided by ACRS will reduce the lessor's required lease payments but that present value must be added to the Government's rental stream to calculate the true cost of the lease to the Government.

A particular characteristic of this analytical accounting of Government leasing costs that I should like to call to your attention is one that has been discussed already today. That is that this computes all amounts as pre-tax or market price magnitude. Consistent with correct use of pre-tax values, the form of analytical accounting for leases I have outlined does not include offsets or reflows for the taxes on the income earned by lessors and their lenders.

That is, just as the cost of hiring a Government employee is not reduced by the taxes that employee will pay in proper accounting, the cost to the Government of the rents paid to lessors should not be reduced by the taxes they pay on that income.

The only tax amounts that should be included in evaluation of the lease are those that are unique to the lease transaction as opposed to Government purchasing and borrowing: those of the value of investment tax credit and tax deferral value of ACRS.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF J. GREGORY BALLENTINE, DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS) DEPARTMENT OF THE TREASURY

Mr. Chairman and members of the Subcommittee: I am pleased to have the opportunity to appear before you today to discuss Federal contract leasing practices in general and the Navy TAKX program in particular

IN GENERAL

I would like to begin my testimony by describing briefly a typical type of leasing transaction which is commonly called a "leverage lease." A leverage lease generally involves three parties: a lessor, a lessee, and a lender to the lessor. In the usual case, the lessor will purchase the property to be leased, financing the acquisition with a down payment of (say) 30 percent of the cost of the property, and borrowing the balance from a third party lender. The property is then leased to the lessee on a net lease basis (i.e., the lessee has agreed to bear the everyday operating costs of the property) for a term that covers a substantial part of the useful life of the property. The lessee's rental payments to the lessor, together with the expected residual value of the property at the end of the lease plus the anticipated tax benefits on the property, are generally sufficient to discharge the lessor's payments to the lender, repay the lessor's investment and provide the lessor a reasonable return on that investment. If the transaction is considered a "true" lease for Federal tax purposes, the lessor will be considered the owner of the property. In that event the lessor will be entitled to claim the investment tax credit and cost recovery deductions attributable to the property and will be required to report the lessee's payments as rental income.

If the transaction fails to qualify as a true lease for Federal tax purposes, the purported lessee would be treated as the owner of the property and the purported lessor would be viewed as merely financing the lessee's purchase of the property. In that case the lessor would not be entitled to any investment tax credit or cost recovery deductions with respect to the property. Any amount received by the lessor as "rent" under the agreement generally would be considered payments of the sales price of the property, on which the lessor may have gain or loss. The lessee would not be entitled to any rental deductions for payments under the agreement, but would instead acquire a basis in the property generally equal to the principal amount payable over the term of the agreement. In addition, as the property's owner, the lessee would be entitled to claim any investment credit or cost recovery deductions allowable with respect to the property.

The determination of whether a transaction which is a lease in form is in fact a lease for Federal tax purposes or whether it is a conditional sale or other form of financing arrangement will depend on the facts of the particular case. The issue of a transaction's status as a lease or a mere financing arrangement has been litigated many times. There are no definitive criteria used for categorizing such transactions under current law. In the case of *Frank Lyon Co.* v. *United States,*[1] the Supreme Court stated that a transaction will be treated as a true lease for tax purposes where "the lessor retains significant and genuine attributes of the traditional lessor status." The Court went on to explain, however, that "what those attributes are in any particular case will necessarily depend on its facts."

REVENUE PROCEDURE 75–21

While no specific formula for a true lease exists, in 1975 the Internal Revenue Service published Revenue Procedure 75–21 [2] which contains a set of guidelines in-

[1] 435 U.S. 561 (1978).
[2] 1975–1 C.B. 715.

dicating the conditions under which the Service will issue advance rulings requested by interested taxpayers on whether certain transactions are true leases of property for Federal tax purposes. These guidelines, which have been supplemented and amended several times, do not (and are not intended to) define the factors necessary to having a true lease for Federal tax purposes. Rather, they merely outline the circumstances under which the Service will issue an advance ruling. Indeed, there are a number of court decisions upholding the parties' characterization of a transaction as a lease even though the transaction would have failed to meet the conditions of the Service's guidelines.

In general, before the Service will issue an advance ruling on the status of a leasing transaction, the guidelines require (i) that the lessor have, and maintain throughout the lease term, a minimum "at risk" investment in the property equal to 20 percent of the property's cost; (ii) that the residual value of the property at the end of the lease term be equal to at least 20 percent of its cost; and (iii) that the property have a remaining useful life of 20 percent of its originally estimated useful life. In addition, the lessor must show that it expects to receive a profit from the transaction exclusive of tax benefits. The guidelines also restrict the use of options allowing the lessee to purchase the property for less than the property's fair market value, and the use of lessee loans to the lessor or guarantees of any indebtedness incurred by the lessor to purchase the property.

SERVICE AGREEMENTS

Service contracts or agreements, as such, are not expressly dealt with in Revenue Procedure 75–21. The use of service contracts has significance for Federal tax purposes in cases where a direct lease of the property to its ultimate user would limit the amount of tax benefits available to the owner of the property. For example, under section 48(a)(5) of the Internal Revenue Code, the direct use of property by a governmental unit or tax exempt entity under a lease agreement would generally operate to disallow any investment tax credit otherwise available with respect to the property. In contrast, if the parties enter into a valid service agreement under which the owner itself will use the property in performing services for the governmental unit or tax exempt entity, the investment tax credit limitation may be avoided.

In a typical lease, a lessor will transfer possession and control of the property to the lessee for the term of the lease, and the lessee will be responsible for its day-to-day operation. In contrast, under a valid service agreement, the ultimate user of the property may be able to direct when and where the property is to be used; but control, possesison, and day-to-day operation of the property remain with the supplier of the service.

Whether an agreement is a service contract or a lease is an inherently factual determination. The Service has issued several published and private rulings on attempts to use service agreements to avoid the investment tax credit limitation in section 48(a)(5). In one ruling the IRS concluded that rental agreements under which copying machines were placed with tax exempt organizations and governmental units were not service contracts (thus ruling that the machines did not qualify for the investment credit), reasoning that the supplier of the equipment had given up possession and use of the equipment to such an extent that the user was able to provide services for itself.[3] This conclusion was later rejected by the Court of Claims in *Xerox Corp.* v. *United States*[4] where the court interpreted the facts differently and held that the taxpayer "was providing a service to its customers under the rental agreements with the machines an integral part of this service."

NAVY PROGRAM

You have asked us to comment on whether the IRS would characterize the Navy Department's "convert and charter program" for one of its 13 TAKX ships as a valid lease and service contract. The transaction, very simply, is structured as a net lease of the ship by an investor partnership as lessor to an unrelated corporation as lessee. The lessee, in turn, will time charter the vessel to the Navy Department under a time charter party. The initial period of the time charter is for 5 years with 4 successive options for the Navy to renew the charter agreement for 5 years each.

Although the IRS has reviewed the agreements relating to the Navy transaction that were supplied by the Subcommittee, it would need more information before it

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[3] Rev. Rul. 71–397, 1971–2 C. B. 63.
[4] 656 F.2d 659 (1981).

could render its opinion on the validity of the lease (the bareboat charter) and service contract (the time charter). But even if the Service possessed all the relevant facts, the Service could not express an opinion publicly on the transaction since the transaction involves known taxpayers. However, is should be noted that the IRS has ruled favorably on similar arrangements in the past, although each case is different and must stand on its own facts.

TAX INDEMNIFICATION AGREEMENT

You have also requested that we comment on the tax indemnification provision included within the "Time Charter Party" agreement.

In a typical lease arrangement, the rents charged are a function, among other factors, of the tax benefits attributable to the leased property that may be available to the lessor. In other words, the availability of the tax benefits on the leased property are an essential component of the lessor's return on the transaction. If the transaction ultimately is found to be a mere financing transaction rather than a valid lease, any tax benefits will be available to the lessee rather than the lessor. It is not uncommon, therefore, for a lease agreement to provide that the lessee will indemnify the lessor against the loss of the anticipated tax benefits.

In the Time Charter Party, the Navy Department has agreed to indemnify the ship's owner, under certain circumstances, for the loss of cost recovery deductions and the investment tax credit with respect to the ship. This provision appears to be consistent with the normal business practice of insuring that the benefit of the bargained for tax deductions and credits are available as anticipated by the parties.

GOVERNMENT LEASING

I will now discuss the economics of government leasing with particular emphasis on the role of financing costs and correct, consistent budget accounting for private capital formation incentives.

One financial aspect of Government lease arrangements generally substitutes private financing for Federal borrowing. Since the Federal Government can always borrow at lower rates than private borrowers, this financial aspect favors Government purchases with Federal borrowing over leasing. I should like to stress, however, there frequently are other financial aspects of a lease arrangement or other cost or policy advantages that can make leasing the preferred alternative.

It is helpful to distinguish two kinds of fact situations concerning the use by the government of durable capital goods. In one situation, the legal arrangements combine the leasing of durable goods with a contract for services not necessarily or customarily performed by the government. In such cases, the rental or lease charges are only partially determined by the capital costs comprising the "net lease" terms I have described above; management and other costs of producing the services associated with the capital goods loom larger. Frequently, in these situations, evaluation of the management and other cost differentials as between government ownership and leasing are closely, if not inextricably, combined with the "lease-buy" choice. Indeed, in view of the discipline of competition to which private ownership and management of this kind of assets in subject, in this fact situation there may well be an efficiency presumption favoring leasing over government ownership and management.

In contrast, the other fact situation concerns those instances in which few if any services associated with the asset are contracted for, or, if there are associated services, there are of a kind customarily performed by government. In these cases, the only relevant aspect of the lease-buy choice is the difference in financing method. Whether the government leases or buys, it will ultimately manage the asset in the same way, incurring the same operating and maintenance costs, and deriving the same flow of services. In such a fact situation a major difference in budget cost as between buying or leasing becomes financing cost. Even in this situation other cost advantages may make leasing the more attractive alternative.

In general, because Federal Government loans are perceived by lenders to be virtually riskless, the government enjoys a borrowing rate lower than that of private parties. Moreover, due to the unavoidability of certain transaction costs inherent in Federal loan guarantees, private borrowing rates even on guaranteed loans range up to 150 basis points (1.5 percentage points) higher than on direct government borrowing. Thus, under a leasing arrangement with the government which in effect guarantees the lessor's own loan go finance the acquisition of the asset to be leased, the cost of funds will be higher than if the government purchased the asset and financed the purchase by borrowing. In these instances in which there is no question of managerial difference and no other financial lease advantages, the lower govern-

ment cost of funds yields a predisposition favoring outright government ownership over leasing. Government ownership avoids incurring fundraising transaction costs that are unnecessary to accomplish the government objective that will be served by the capital good.

Of course, in the real world of government operations, the task of distinguishing those fact situations in which there is a presumption in favor of leasing from those in which the presumption favors outright government ownership is not an easy one. Other policy objectives of government may be served on occasion by a leading arrangement that justifies somewhat higher financing costs; and differences in budgetary tracks for procurement and operation and maintenance programs may cause leases at particular times to result in real cost savings that more than offset higher financing costs. For example, the TAKX charter periods were structured in 5-year periods which gives the Navy the flexibility to terminate the contracts if our defense needs change without the U.S. Government bearing a potentially substantial loss on the residual value of the ship. Therefore, I question whether there can be a simple policy favoring or disfavoring leasing by government. Rather, the need is for procedures and techniques for evaluating lease-buy choices, a subject to which the remainder of my remarks is addressed.

Demonstration of the intuitively obvious truth that leasing, per se, cannot reduce the government's cost of obtaining the use of durable capital goods is complicated by budgeting conventions. The unified budget is fundamentally a document summarizing cash inflows and outflows, and, therefore, does not lend itself to portrayal of the annual costs of service from durable assets. In particular, budget accounting for obligational authority and outlays does not distinguish between a single capital outlay to provide services for many fiscal year and other outlays to cover a single year's service.

If the government invests in a ship that is expected to provide a stream of military services over, say, 25 years, the cost of acquiring that ship—$184 million in the case before you—appears in the budget as that much obligational authority in the year in which it is appropriated and as outlays during the year(s) in which the procurement occurs. However, it can be shown that for particular assumptions as to the 25-year stream of effectiveness and government borrowing cost, if the annual cost could be shown as lease rentals, they would be $20.3 million a year. At the government's borrowing rate, which is the budget cost of shifting payments over time, this stream of annual outlays would be exactly equivalent to the $184 million (single year) outlay in terms of social cost. Moreover accounting for the cost of the ship as a $20.3 million outlay annually has the additional valuable attribute of correctly distributing its full cost over the 25 years of that ship's service to the country.

Thus, leasing could actually contribute to better budgetary control of government programs. If a lease arrangement yields a set of annual lease rental costs that approximately matches the expected stream of services to be realized from the leased asset and which, when discounted, costs no more than outright purchase, then leasing rather than outright purchase has the virtue of distributing budget costs to be financed by taxes among successive generations of taxpayers who enjoy the benefits. The same result might be achieved, for example, if government agencies contemplating the acquisition of durable assets were required to finance the purchase through the Federal Financing Bank under an agreement by which they obligate themselves to service and retire the debt thus incurred over the period the asset will be in productive service. The annual budget charge for debt service and retirement under such an arrangement would be, of course, substantially the same as a lease rental; but since the annual charge would reflect the government borrowing rate, budget cost would be minimized. The potential benefit of leasing for the budgetary process has been recognized by OMB in Circulars A-94 and A-104 which provide guidance in the selection of a discount rate and for evaluating the choice whether to lease or buy.

However, there are additional problems posed by budget accounting conventions that confound evaluation of potential government leases by simply discounting proposed lease rentals at the guideline government borrowing rate. These problems, to which I now turn, will invariably cause an understatement of the budget cost of leasing. If these problems are not carefully resolved, they will not only bias the lease-buy choice in favor of leasing, they may lead to the acceptance of leases that impose higher costs than outright purchase and that nevertheless understate problem costs.

These budget accounting problems are rooted in provisions of the income tax laws that have been designed to encourage private capital formation. Specifically, the Investment Tax Credit (ITC) and Accelerated Cost Recovery System (ACRS) reduce the private cost of acquiring and using assets. These incentives were introduced to help

offset the income tax deterrence to private capital formation. Since in a "true" lease arrangement the lessor will receive the ITC and can depreciate his asset using the ACRS schedule, the effect of these incentives is to reduce the lease rentals a private lessor must charge to recover his own investment in the asset and to earn his rate of return. When the government is the lessee, it pays these lower rentals, which will appear as outlays, but the budget will not associate with the program supported by these lease rentals the reduction in tax revenues which made these lower budget outlays possible. I shall illustrate the nature of these problems in the case of the ITC and ACRS.

The ITC operates to reduce the private cost of acquiring a qualified asset in much the same way as does a capital grant. The ITC therefore proportionately reduces any lease rentals that must be charged. If the ITC were paid directly to the owner with appropriated funds, the amount of the grant would appear in the budget among the outlays and would be associated with the program that is thus supported. But since the ITC is taken as a credit against income tax otherwise due, the budget effect is merely a reduction in tax deposits (receipts) and is not associated with the program it supports. Proper evaluation of a government lease therefore requires that account be taken of the ITC allowed the lessor at the beginning of the lease term by effectively adding the ITC to the rental stream being discounted.

Accelerated cost recovery with respect to the portion of the asset's cost representing the owner-lessor's own investment of private funds affors him the benefit of tax deferral. For example, the Navy lease of cargo ships which you are reviewing extends for 25 years. Twenty-five years is thus the period over which the lessor would predicate recovery of his recoverable costs in determining his annual lease rental charges, yet the ACRS provisions of the Code permit him to recover this in tax deductions during the first 5 years of the ship-lease term. As a consequence, the lessor will deposit less tax during the first 5 years of the lease contract, more during the remaining 20 years, hence the descriptive term "tax deferral." The present value of this tax deferral will reduce the lessor's required lease payments, but that present value, like the value of the ITC, must be added to the government's rental stream to calculate the true cost of the lease to the government.[5]

Obviously, if the full budgetary consequences of lease rentals on both the outlay and revenue side of the budget are accounted for an discounted at the government borrowing rate, the choice whether to lease or buy will hinge on the total cost to the Government under the two alternatives. This total cost will include tax costs, financing costs, and any other cost differences.

In those cases in which government leasing is justified, the budget cost of the lease can be minimized if the private financing is arranged through the Federal Financing Bank, which is authorized to finance government guaranteed obligations. I understand that Navy Department officials are inquiring into these possibilities with regard to the leases under review.

The particular characteristic of this analytical accounting of government leasing costs that I should like to call to your attention is that it computes all amounts as "pre-tax," or market price magnitudes. This follows the convention used in both our national accounts and budgeting which takes market prices as the measure of both product (GNP) and income payments, or shares. In budgeting, the rationale for using pre-tax magnitudes is that, on the expenditure side, these represent the opportunity costs of the resources devoted to public purposes; on the revenue side, pre-tax magnitudes represent the share of national product taken as taxes. Thus, the adjustments to lease rentals I have suggested above simply perform the function of expressing the full resource costs of government leases in terms that are consistent with other expenditures, including procurement of an item that might be leased.

Consistent with the correct use of pre-tax values, the form of analytical accunting for leases I have outlined does not include offsets for the taxes on the income earned by lessors and their lenders. That is, just as the cost of hiring a government employee is not reduced by the taxes that employee will pay, the income paid to lessors should not be reduced by the taxes they pay on that income. The only tax amounts that should be included in the evaluation of the lease are those that are unique to the lease transaction as opposed to government purchase and borrowing. Those are

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[5] Present values never appear in budgets, only annual cash flows. Thus, when tax is deferred, tax deposits diminish and increase the deficit, in the same manner as net lending. In later years, as the deferral is repaid (assuming no new investment to generate deferrals), tax deposits rise. The present value of the deferrals exceeds that of the repayments, and this may be likened to positive "average" tax deferral over the life of the lease. Naturally, this average deferral implies some net average government borrowing. The deferral benefit is therefore the interest avoided by the lessor, the consequences of which are interest payment outlays.

the value of the ITC and the tax deferral value of ACRS. This procedure is in accordance with the general reason for maintaining government and national accounts in pre-tax magnitudes, namely, so that the sum of government and private sector activity will represent the national product (GNP).

CONCLUSION

There are six basic points made in my testimony:

(1) Whether or not specific transactions are characterized for tax purposes as a lease or a financing transaction is a factual issue that cannot be determined without an examination of all the details of the purported lease arrangement.

(2) Similarly, whether or not a specific transaction is a valid service contract for tax purposes is a factual issue that cannot be determined without an examination of all the details of the agreement.

(3) Since the transactions in question involve known taxpayers neither the Treasury nor the IRS can comment publicly on their validity.

(4) To the extent that a lease arrangement simply involves substituting private financing for public financing, it is more costly than a direct purchase.

(5) In many cases other cost and policy advantages can dominate any additional financial costs of leasing.

(6) Proper accounting for the costs of a Government lease arrangement must include the revenue cost from allowing the Investment Tax Credit and the deferral advantage of ACRS.

This concludes my remarks and I will be happy to respond to any questions you may have.

Chairman RANGEL. Thank you.

Mr. Sowle.

STATEMENT OF DONALD SOWLE, DIRECTOR, OFFICE OF FEDERAL PROCUREMENT POLICY, OFFICE OF MANAGEMENT AND BUDGET

Mr. SOWLE. Good afternoon, Mr. Chairman. I would like to also shorten my statement, but I would still like to go through it in general because it responds to the questions you sent to OMB, Mr. Chairman.

Chairman RANGEL. Without objection.

Mr. SOWLE. I would like to start off by saying that the Federal procurement policies and implementing regulations cover primarily the direct purchase of goods and services, while providing limited guidance in the area of leasing. There are, however, instances where leasing is preferable to purchase—from both an economic and programmatic point of view. Existing policies and regulations do provide guidelines to assist Government officials in making those lease or purchase decisions.

I have structured my testimony, Mr. Chairman, to respond to the 10 questions contained in your letter of invitation, dated February 14, 1983.

ROLE OF OMB

As a staff office to the President, OMB reviews and evaluates the budget request of each agency and makes recommendations to the President concerning budget matters. Prior to making such recommendations, budget items or programs may be questioned by OMB and differences resolved with the agencies. This process includes the review of agency proposals to lease or procure property.

OMB's role in procurement is to develop government-wide procurement policy. I have the lead responsibility for this in my role as the Administrator for Federal Procurement Policy. In perform-

ing this function, however, I am not involved in reviewing or approving specific procurement programs or contracting actions. OFPP is precluded, by statute, from interfering in individual procurement determinations.

AGENCY PROCUREMENT AUTHORITY

Nearly all executive agencies have authority to acquire Federal property. This authority is generally provided in the organic statute which establishes the Executive Department or agency. Except for the reviews associated with the budgetary process, which I have described, OMB does not review such purchases.

NAVY AND AIR FORCE LEASING PROGRAMS

With respect to the specific Navy and Air Force leases cited in your third question, OMB examined the leasing programs for the Navy's TAKX and T-5 ships, as well as the Air Force's C-140B and CT-39 replacements. In all of these programs, military needs, as well as policy and financial considerations, were involved.

In each instance, leasing costs appeared to be reasonable, and the military needs appeared to be better satisfied by the leasing alternative. All of the proposed leases were reported by the Department of Defense to the appropriate oversight committees of the Congress, as has been pointed out earlier today.

We understand that the Navy has no plans for leasing the F-16 aircraft to which you referred, the TAO oil tankers, or a hospital ship. In addition to the programs I have just mentioned, we understand that the Air Force is considering the lease of Civil Reserve Air Fleet aircraft and a Tanker Transport Bomber training aircraft. No decisions, however, have been made thus far on these programs.

LEASING AS A PROCUREMENT TECHNIQUE

As a procurement technique, I would like to emphasize that, properly employed, leasing is a legitimate and useful contracting method. It is a technique available to virtually all Federal agencies, both defense and civilian. We are not aware of any overall trends in the use of long-term, high-cost leasing arrangements but we do know that the use of such contracts is not unique to DOD.

LEVERAGED LEASING

Other than those programs which I have already mentioned, Mr. Chairman, we are unaware of any plans by any agency to employ leveraged leasing of property that has traditionally been obtained through direct procurement.

BUDGETARY IMPACT OF LEASING

With respect to the budgetary impact of leasing, in general, the primary difference between leasing and direct procurement is in the timing of the outlays. When the property is acquired directly, the outlays occur at the time of acquisition. Under a leasing arrangement, the outlays occur over the life of the lease. The Navy's budgets for fiscal years 1983 and 1984 were developed on the basis

of chartering the TAKX ships. Assuming that all other programs in those budgets were to remain the same, shifting to direct procurement in lieu of leasing would require a near-term increase in both budget authority and outlays.

We understand that the existing charter contracts for the 13 ships provide an option for procurement after the conversions are completed. If those options are exercised to buy rather than lease, however, increased defense outlays in 1984, 1985 and 1986 would be needed.

OMB LEASING POLICY

There are two OMB policy documents that agencies must consider when contemplating leasing, as opposed to purchase: OMB Circulars Nos. A-94 and A-104.

OMB Circular A-94 provides policy guidance to executive agencies on analyzing personal property and program transactions. It prescribes a standard procedure to be followed by agencies in evaluating measurable costs and benefits to programs estimated to extend for 3 or more years. The circular prescribes a discount rate and procedures for ascertaining benefit-cost ratios of competing alternatives.

OMB Circular No. A-104 provides policy guidance to agencies for analyzing real property transactions. It requires agencies to conduct comparative cost analyses prior to acquiring real property valued at $500,000 or more. The analytic procedures prescribed by A-104 provide for the projection of all costs associated with the two alternatives, leasing versus purchase.

The projected cost of each alternative, after adjusting for inflation, is then discounted at a standard rate to determine its present value. The alternative with the lowest present value represents the most economical choice.

We believe that each of these circulars is fundamentally sound. As part of the President's reform 1988 management program, however, Circulars A-94 and A-104 have been identified as candidates for updating and revision, as necessary. We are hopeful that these hearings today, Mr. Chairman, will be helpful in identifying any specific improvements which may need to be made in those circulars.

TAX CONSEQUENCES OF LEASING

With regard to your questions about the existence of any OMB policies concerning the tax consequences of leasing transactions, Circulars No. A-94 and A-104 require all cost-benefit calculations be performed using pretax data. The "pretax" analysis does not explicitly account for loss of tax revenue as a result of the accelerated cost recovery system (ACRS) or the investment tax credit (ITC). However, neither does it explicitly account for the revenue gain resulting from taxes paid by the lessor. In a competitive lease-or-purchase situation, as in the case of the Navy ship-leasing program, it is assumed that market forces will result in lower costs being passed back to the Government in the form of rent-or-purchase prices.

Further, using pretax or market price data follows the convention used in both the national income accounts and the budget.

LEASE PROVISIONS

In response to your question concerning compensation of lessors for unfavorable economic events, unfavorable IRS rules, or legal fees, Federal contracts may contain specific clauses which provide that the Government will assume the risks of certain costs. These provisions have been utilized to cover fluctuations in the price of raw materials, rapidly increasing costs of money, termination liability, differing site conditions (in the case of construction contracts), and other contingencies. Such provisions are necessary to avoid excess charges by the contractor for contingencies that may never develop. Generally, legal fees are considered a cost of doing business and are included in the indirect or overhead account.

XEROX CASE

You asked for OMB's opinion of the ruling in *Xerox Corp.* v. *United States*—and the effect of that case on Federal procurement activities. We have read the case and note the court's admonition that its opinion does not lay down a general rule applying to copying machines or other machines, and that each case must rest upon its own factual merit. Because of this admonition, we have not made any changes in Federal procurement practices which have occurred as a result of this case.

GENERAL COMMENTS

In addition to the questions posed by the subcommittee, Mr. Chairman, you also asked that we consider three general policy issues identified by your subcommittee; namely, the extent of Federal revenue losses resulting from leasing arrangements such as those employed by the Navy, whether agencies consider such losses in contemplating such transactions, and whether agency use of such arrangements circumvent the congressional budget authorization and appropriation process.

Circulars A-94 and A-104 are based upon pretax considerations. Therefore, revenue losses are not required to be calculated. However, revenue gains (that is, income taxes paid as the result of Government leasing or purchasing activity) are also not reflected in the calculations. Although agencies are not required to do so, the Navy has apparently endeavored to reflect revenue losses in its calculations for the leases in question.

In conclusion, we are convinced that the use of such leasing arrangements is not an effort on the part of agencies to circumvent congressional processes. As I noted earlier, leasing arrangements are selected for both economic and programmatic reasons. Deception of the Congress or circumvention of its processes are not intended, and we believe that the Navy has acted in good faith and in openness with the Congress.

Mr. Chairman, this concludes my statement. I will be pleased to respond to any questions you may have.

Chairman RANGEL. Mr. Beres, from General Services Administration, Associate Administrator for Acquisition Policy.

STATEMENT OF ALLAN W. BERES, ASSOCIATE ADMINISTRATOR FOR ACQUISITION POLICY, GENERAL SERVICES ADMINISTRATION

Mr. BERES. Thank you, Mr. Chairman.

GSA was not privy to the decision by the Department of the Navy to charter for cargo-carrying vessels. Consequently, I am not in a position to comment on the transaction or the analysis by which the Navy concluded that the charter arrangement was the most advantageous to the Government.

Leasing is not a practical acquisition alternative for many of the common use, commercial-type products purchased by GSA in support of its various missions; however, the lease versus purchase consideration is an important one in certain areas. This is true particularly with respect to the acquisition of building space and ADP/telecommunications equipment.

GSA has issued a number of regulations requiring consideration of the most economic acquisition alternative, with respect to these procurements. However, the basic policy establishing the economic analysis to be followed in considering the leasing alternative has been promulgated by the Office of Management and Budget. GSA follows these OMB guidelines in its decisionmaking.

Neither the OMB guidelines nor the GSA regulations specifically provide for consideration of the tax consequences of the transaction to the potential contractor. What is significant is consideration of the alternative which will result in the lowest overall acquisition cost to the Government. To the extent that an offeror may take advantage of tax considerations in structuring his offer, his cost savings may potentially accrue to the Government in the form of lower prices.

GSA has not experienced a recent "trend" toward leasing property. Indeed, generally speaking, GSA prefers to purchase rather than to lease. This is particularly true in the area of real property, where the agency is trying to move toward the Government-ownership alternative. Although historically, leasing has often been chosen as the most economic alternative for housing Federal agencies, the national average cost for federally leased space has risen significantly. Consequently, purchase or construction of buildings for Government ownership is favored in the economic analysis. However, even in such cases, budget restraints may make leasing the only viable alternative. We are presently preparing a 5-year management plan for submission to Congress which will propose a shift to increased ownership of space and a major reduction in our dependence on leased space to satisfy the long-term housing needs of our client agencies.

Specific answers to the questions posed in your February 14, 1983, letter are herewith submitted for the record.

[The information follows:]

GENERAL SERVICES ADMINISTRATION RESPONSE TO SPECIFIC QUESTIONS CONCERNING FEDERAL LEASING PRACTICES

Question 1. To what extent does the General Services Administration (GSA) have review and approval authority for Federal leasing and procurement activities?

Answer. Generally, GSA neither reviews nor approves the specific leasing and procurement actions of the Federal agencies where GSA has established applicable standards. Additionally, with certain exceptions, under the "Brooks Act" (Section 111 of the Federal Property and Administrative Services Act of 1949) agencies must receive GSA authorization to procure ADPE.

Question 2. What GSA policy guidelines and rules must be considered by Federal agencies contemplating the leasing, rather than purchase, of Federal property?

Answer. GSA has issued a number of regulations pertaining to this subject: FPMR 101-25.5 prescribes lease/purchase guidelines for certain types of equipment; FPR 1-4.11 and FPMR 101-35.2 establish guidance in the area of ADPE; and FPMR 101-18.1 pertains to building space. Generally, these regulations require consideration of the most economic financing alternative. However, it should be noted that executive agencies are subject to Office of Management and Budget guidelines concerning the economic analysis involved in decisions to lease property. Specifically, OMB Circulars A-94 and A-104 deal with personal and real property leasing, and are controlling in this area.

Question 3. To what extent has the GSA switched from direct acquisition practices to leveraged leasing? Please describe the reasons for any such shift and its impact on overall Federal procurement activities.

Answer. We understand that leveraged leasing involved financing a lease transaction by the owner with third party debt. As a matter of procurement policy, the method by which the owner or lessor finances the acquisition of the property to be leased to the Government is a decision solely belonging to him. Accordingly, GSA is not directly involved in leveraged leasing. Decisions by GSA concerning an award of a lease do not take into account the method by which a particular lessor may choose to finance his acquisition of the property. However, all lessors must be found to be financially responsible.

Question 4. Does GSA prescribe the tax consequences of leasing transactions for purposes of evaluating the Federal costs of a lease versus a purchase transaction? How are the tax benefits of ACRs depreciation, the investment tax credit and other business deductions officially taken into account in the analysis process?

Answer. No. With respect to the acquisiton of building space, only the property tax consequences of leasing transactions are considered in the evaluation of Federal costs of a lease versus a purchase transaction. This is in accordance with OMB Circular No. A-104. To the extent that tax consequences of particular transactions effect an offeror's anticipated costs in fulfilling a Federal requirement, they will be reflected in the offered price. The GAO, however, has held that predicting tax liability effects in connection with Government procurements would be speculative.

Question 5. Are there rules regarding (a) the types of property that cannot be the subject of a leasing arrangement, (b) the maximum length of time a lease contract can cover, or (c) the maximum dollar amount of a lease contract?

Answer. (a) Not to our knowledge. (b) & (c) Fiscal statutes such as the Antideficiency Act and the type of appropriations on funds an agency receives will have a bearing on the length of time and the amount that an agency can obligate funds under a lease contract for a term of years. Additionally, agencies may have specific multi-year contracting authority. For example GSA has specific statutory authority to lease real property for periods not-to-exceed 20 years.

Question 6. To what extent can the Federal government contract to compensate lessors, in the form of adjusted lease payments or otherwise, for the occurrance of unfavorable economic events, unfavorable IRS rulings or legal fees?

Answer. As a matter of procurement policy, the Federal Government will assume certain risks that would otherwise influence Federal bidders in their development of bid prices and cost proposals. By removing such contingencies from a contractors' offer, we ensure that the Government does not pay for circumstances and conditions which may never occur. GSA has not generally provided for contract price adjustments in its contracts in the event of unfavorable IRS rulings, or legal fees. However, GSA does use Economic Price Adjustment provisions to cover the economic uncertainties of long-term contracting. We think these provisions provide for a reasonable distribution of the risk incident to inflation.

Question 7. What is GSA's opinion with regard to the holding in *Xerox Corp.* v. *U.S.*, 656 F.2d 659, (Ct. Claims 1981). How has this case changed Federal procurement activities?

Answer. We are not aware that Federal procurement activities have changed as a result of *Xerox Corp.* v. *U.S.*

Mr. BERES. Other than the extent of our review authority, generally GSA neither reviews nor approves specific leasing or procurement action of the Federal agencies where GSA has established applicable standards.

Additionally, with certain exceptions, under the Brooks Act, section 111 of the Federal Property Administrative Services Act of 1949, agencies must receive GSA authorization for procurement of automatic data processing equipment. Other than that the answers previously pertained to GSA.

Chairman RANGEL. Thank you.

Mr. Sowle, is it your testimony you never took into consideration the tax expenditure as related to the Navy proposals?

Mr. SOWLE. The two directives that apply to leasing do not specifically take onto account the loss of tax revenue.

Chairman RANGEL. They don't mandate it and you didn't do it.

Mr. SOWLE. That is right. As I mentioned, we are in the process under the reform——

Chairman RANGEL. I understand. Let me make it clear, I have heard of no member of the subcommittee who is anxious to assess blame for anyone practicing present law. It could well be what was done was not the intent of the Congress. I don't know. But we do want to establish a record as to what was done.

Let me ask you. After hearing the joint committee or having access to other material that you didn't have when you reviewed the Navy's proposal, do you still believe it is more cost effective than a direct purchase?

Mr. SOWLE. Mr. Chairman, in that kind of a situation, the OMB budget examiners look at the acquisition strategy in general terms. They don't get into the various specifics of individual procurements.

Chairman RANGEL. If I wanted to get past an unfavorable recommendation by OMB as relates to the budget, I do a lot better by leasing arrangements than by direct purchases. And without criticism from OMB, because from what you say that is not your mandate.

Mr. SOWLE. Based upon the general review by OMB which I have just mentioned and the testimony given today by the other witnesses, I would certainly agree that tax considerations are not part of the current OMB A-94 and A-104 processes.

Chairman RANGEL. OK. And I gather that OMB does not find it part of their mandate to make any inquiries of the Treasury Department as to what the tax costs would be?

Mr. SOWLE. On the contrary, Mr. Chairman, A-104 and A-94 are old directives which date back to 1972. I think the Treasury, however, was a party, as well as other agencies, in their development.

Chairman RANGEL. Good. Now could you tell me what was the IRS or Treasury response to your A-94, A-104 request as relates to the Navy contract?

Mr. SOWLE. I think all I can say is what has already been presented here. We did not talk to them specifically about this particular program. It wasn't in our charter to do so.

Chairman RANGEL. I will ask the question again. OMB does not find that as a part of their mandate they are to get any analysis of cost expenditures for any leasing program that any Federal——

Mr. SOWLE. Normally not. Yes, sir, that is true.

Chairman RANGEL. And you didn't——

Mr. SOWLE. Because we do not get into individual procurements per se.

Chairman RANGEL. So you didn't get involved in this one either?

Mr. SOWLE. I think that is generally correct, sir, except for the process I outlined.

Chairman RANGEL. You wouldn't give an opinion even if someone asked you; right?

Mr. BALLENTINE. There are two issues. One is the validity——

Chairman RANGEL. On the validity of a lease, you would not offer a legal opinion?

Mr. GRANWELL. Not until we have seen all the facts and circumstances and provided, in the normal course of events, a ruling.

Chairman RANGEL. If they had given to you a year ago what they gave to us this morning, would that have been enough information for you to give them some type of opinion?

Mr. BALLENTINE. Let me distinguish two questions. One is for the IRS to rule if it is a valid lease or service contract.

Chairman RANGEL. That is what I am talking about.

Mr. BALLENTINE. But a minute ago we were talking about how to calculate the level of the tax benefits in the contract correctly.

Chairman RANGEL. All right. I agree with you.

Mr. BALLENTINE. They are two different things.

Chairman RANGEL. I agree. Let's take them one at a time.

Mr. BALLENTINE. OK.

Chairman RANGEL. Now, would the information we have today have been enough for you to have given a legal opinion as to whether or not it was a valid lease?

Mr. BALLENTINE. The information the subcommittee gave to us and passed on to the IRS was not enough.

Chairman RANGEL. Let me try again.

Mr. BALLENTINE. No. The IRS, given what they have seen now, which is all Treasury has seen, do not have enough information to provide a ruling at this stage.

Chairman RANGEL. Do you know that?

Mr. BALLENTINE. Yes.

Chairman RANGEL. Do you know that they need more information?

Mr. BALLENTINE. IRS has told us they would need more information than what has been available to them now.

Chairman RANGEL. As to whether it was a valid lease?

Mr. BALLENTINE. Both the lease, I am dealing with both the lease and service contracts——

Chairman RANGEL. No, you criticized me for doing that, so don't do that. I am talking about only the question of whether it is a valid service contract. That is all I am talking about.

Mr. BALLENTINE. In that case, yes——

Chairman RANGEL. Does the Navy have to produce more documents?

Mr. BALLENTINE. I don't know who has the documents. The IRS does not have the documents at this time. If all the contracts have been signed and are there for inspection, then, yes, there is enough information for the IRS to deal with on the basis of all those documents. But IRS has not seen them at this time.

Chairman RANGEL. You are saying even if they gave you all the information that they ever would have, that you would not have given a legal opinion?

Mr. BALLENTINE. No, I didn't mean to say that. If the IRS has all the documents and the normal request for ruling is made, just as with any other taxpayer, a ruling would be given when the——

Chairman RANGEL. I meant before the signing of the agreements. If Navy had run this by Treasury and said, "This is what we want to do. This is what we think is a valid service contract. We want an opinion." Would you here given it to them?

Mr. BALLENTINE. I am accompanied by Alan Granwell.

Chairman RANGEL. Anyone can answer.

Mr. GRANWELL. Mr. Chairman, in the context of rulings issued by the Internal Revenue Service, the normal procedure is for the relevant taxpayer or taxpayers to submit a ruling request submitting all the documentation. If the IRS has the documentation, and if the documentation otherwise comports with its ruling guidelines in a particular area, it will consider the matter, ruling either positively or negatively or otherwise informing the taxpayer of what its views are.

Chairman RANGEL. You wouldn't consider Navy a taxpayer, would you? So what I am asking is what do you do when the Navy comes in and says that they want to save a couple of dollars, and that they have a proposed agreement? They bring it to Treasury and ask whether or not it is a valid contract.

Mr. GRANWELL. The Navy wouldn't be the taxpayer.

Chairman RANGEL. I am asking whether the Navy can do that under our system of government?

Mr. GRANWELL. I don't believe so.

Chairman RANGEL. Neither could OMB?

Mr. GRANWELL. I don't believe so. In order for the Service to issue a ruling——

Chairman RANGEL. It would be futile for them to come to you and ask anything about tax expenditures or valid contracts? They would have to sign the agreement and then after that, you would review it.

Mr. BALLENTINE. Again you are referring to tax expenditures.

Chairman RANGEL. I was first talking about——

Mr. BALLENTINE. There is another distinction relevant to calculating correctly the cost of the contract in terms of revenue losses. It is very appropriate for Treasury to get involved in setting out the proper procedures for that, but that is different from the case-by-case involvement with specific taxpayers asking for rulings.

Chairman RANGEL. OK. But on the issue of whether or not the U.S. Government saves money on this leasing procedure as opposed to purchase, has the Treasury Department been involved in any discussions with anybody else in government?

Mr. BALLENTINE. We have not at this point been involved in the proper accounting. I think as was recognized we need to provide

clear direction in the OMB directives and Treasury will be involved in that.

Chairman RANGEL. Answer the last question. Will the Treasury Department take into consideration any adverse effect on the Navy's budget in reaching the Treasury's legal conclusion? Will that be a factor?

Mr. BALLENTINE. Absolutely not. That isn't an issue in IRS rulings.

Chairman RANGEL. I didn't think it would be. I just had to ask.

Mr. Pickle?

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Secretary, I want to pursue a line of questioning Mr. Rangel just finished. You don't issue a ruling unless you have a request for one, a taxpayer request? Suppose the Navy comes to you and asks you is it appropriate for us to enter into a lease transaction of this nature?

Let me pose the problem to you. What assistance would you give them? What would you advise them? What would you do?

Mr. BALLENTINE. Yes. I hate to keep going back to the same distinction but it is appropriate. In a lease agreement, in one sense we would have been cooperating in setting out how to appropriately evaluate it. We would have a role in advising them when it is cheaper to do that. Second, whether these contracts, as evidenced in supporting documents, appear to fit the designation of a lease under current law. I think informal conversations could take place on this. Once you go past the informal conversation to a formal conversation you are getting to the point at which we would be offering a ruling. That is the appropriate thing to do when a taxpayer applies for a ruling after a completed deal.

But I don't want to suggest that we don't pick up our phones when the Navy calls.

Mr. PICKLE. Nor do I want to infer you look the other way and refuse to talk to them, because that is not the real world. But I do know you would be expected to respond. Let me put in the record a statement, I believe it is correct; if it isn't, you tell me.

On November 1 and November 4, 1981, Mr. Mark Kensington and J. L. Barston of DOD's Office of Program Analysis and Evaluation, met with Mr. James Halpern, principal technical adviser to the Assistant Commissioner of IRS and Mr. Ed Goldwag, to discuss whether lessors of ships to the Navy would be eligible for ITC and ACRS tax benefits.

Are you aware of that meeting? If you are, what counsel did Treasury give to the DOD?

Mr. BALLENTINE. I don't recall the date of that specific meeting. I was informed just a little while ago of a couple of meetings, informal meetings between IRS and officials of the Defense Department. I don't know specifically what took place at those meetings. I would presume——

Mr. PICKLE. Do you know what advice or counsel was given?

Mr. BALLENTINE. I really don't.

Mr. PICKLE. I would ask you to get that accounting and recommendation, if any, and give it to the committee. Will you do that?

Mr. BALLENTINE. I will be happy to.

[The information follows:]

The meetings between representatives of the Department of Defense and the Internal Revenue Service were primarily a discussion of the general rules for distinguishing service contracts from leases. Also discussed were the investment tax credit rules as they relate to the use of property by a governmental entity and the rules relating to controlled foreign corporations with subpart F income. The discussions were exploratory in nature and did not relate to a specific transaction. No documents were submitted by the Defense Department for review by the IRS.

Mr. PICKLE. Mr. Secretary, just for background purposes, back in 1974, the Acting Assistant Secretary, Mr. Ernest Christian, responded to an inquiry from OMB for their views on the Navy's draft bill to authorize long-term leasing of vessels. Mr. Christian made a very strong statement. I won't read it all because it is lengthy but in essence he says the Department is opposed to this legislation. That is the way he starts it off.

From the standpoint of tax policy, we consider it a bad precedent to permit the Department of Defense to treat financing transactions like leases for tax purposes, a precedent that would no doubt lead to requests for similar treatment by both private and governmental agencies. Also, these are leveraged transactions which would reduce taxable income through depreciation deductions while receiving an investment tax credit at the same time.

He goes on to say it is bad policy from a budget standpoint because it gets into the uncontrollable cost aspect of it. It is a very strong statement. I am sure you are familiar with it.

Mr. BALLENTINE. Yes.

Mr. PICKLE. Is that still Treasury's position now?

Mr. BALLENTINE. Many of the concerns raised in Mr. Christian's letter are still the Treasury's concerns, indeed are raised in my written testimony. In particular, Mr. Christian says his primary objection to the bill is based on two factors. The accounting policy of having certain Navy, in this case, expenditures not appear on budget, and thus appear to suggest by direct accounting that the program is less costly than it is.

Second, the budget policy that I mentioned in my testimony, by effectively requiring private financing instead of Government borrowing, will be more costly. Those factors we still would say are our concerns with this kind of arrangement.

Mr. PICKLE. That is good.

Mr. Christian did delineate those two as his primary concerns, cost and why it doesn't really show in the budget.

Mr. BALLENTINE. That is correct.

Mr. PICKLE. I want to ask you, earlier this morning, I don't know whether you were here, I distributed or had a chart out which showed an analysis of the Joint Tax Committee with respect to the costs of this transaction.

Mr. BALLENTINE. Yes.

Mr. PICKLE. Were you there then?

Mr. BALLENTINE. I was not. I have looked at and read——

Mr. PICKLE. In this column it shows that if the Navy entered into a purchase contract, the cost would be $178 billion. If they leased, according to the contract figures, the ships, the cost would be $141 billion. That is approximately $38 billion difference to the Navy. But, the actual cost per ship to Treasury would have to be some $58 billion under the lease option. If you leased it, total cost would

be $198 billion. So, each ship's lease would cost about $20.8 million more compared to purchasing.

I am just asking in general—these figures may be a little different from the Navy's actual figures because I think we are all dealing sometimes with variable though they are right essentially. Do you agree with this general analysis? On the total cost to the Government?

Mr. BALLENTINE. This analysis is restricted to the financial gains or losses from leasing as opposed to buying. In that regard, the Navy testified there were other considerations. I don't want to comment on those other considerations.

Mr. PICKLE. All right.

Mr. BALLENTINE. With regard to these we would basically agree with the way the Joint Committee has gone about its estimates; with small differences we basically agree with what they have done in accounting for tax losses, as I said in my testimony. From a pure financing standpoint, leasing effectively substitutes private for government financing, and that must cost more.

There are considerations that Navy testified to, not matters about which I have any expertise. They could outweigh this. But our accounting would be similar to the Joint Committee in this regard.

Mr. PICKLE. Then the net of it is that you do agree generally. I assume the Joint Tax Committee had discussed this in general with Treasury.

Mr. BALLENTINE. Yes.

Mr. PICKLE. And it is agreed to by CRS. Essentially we must all agree that the total cost to the Government is as shown on this chart.

Mr. BALLENTINE. Yes.

Mr. PICKLE. That means then that the Navy, perhaps with good motive, though, has shifted a great deal of this cost of the project to the Treasury instead of——

Mr. BALLENTINE. Dealing only with total financial cost, not with other cost considerations Navy testified to. In terms of financial costs, we would agree.

Mr. PICKLE. Yes. Now, and this would concern the Navy—this concerns you. I would assume that you are studying what action to take. Can you tell me when you expect IRS to make a ruling on the question?

Mr. BALLENTINE. It is my understanding no rulings have been requested as of yet. So, I really couldn't give you in good faith——

Mr. PICKLE. I thought rulings had been requested of IRS? You don't have an official request from anybody yet whether this is a good or bad ruling?

Mr. BALLENTINE. That is my understanding, yes.

Mr. PICKLE. I wonder why that is, Mr. Chairman. You mean the Navy hasn't asked you for a ruling?

Mr. BALLENTINE. That is my understanding.

Mr. PICKLE. Mr. Secretary, even though no one has asked for a ruling, when the delivery is made of the ships there must be a determination at that point, must there not?

Chairman RANGEL. Not unless it is requested.

Mr. BALLENTINE. I wouldn't think in the normal course——

Mr. GRANWELL. Mr. Pickle——

Mr. PICKLE. In other words, we are sitting here wondering whether IRS is going to make a favorable or unfavorable ruling with regard to this transaction, and if it made an unfavorable ruling, that means, since they have pledged the faith and credit of the United States Treasury through the Navy, that they would spend at least $250 million more. We won't know unless somebody asks for a ruling.

And you are telling me nobody has asked for a ruling?

Mr. BALLENTINE. That is our understanding.

Mr. PICKLE. Mr. OMB, does that concern you? Have you asked for a ruling?

Chairman RANGEL. OMB?

Mr. SOWLE. Oh, excuse me.

Mr. PICKLE. Are you all just going to sit on the sideline and say it is a very interesting question? I hope this thing is——

Mr. SOWLE. I think, Mr. Pickle, this is a particular case. As I mentioned before, OMB doesn't get into the internal management of the agencies, per se. The Department of Defense has a responsibility for managing its funds, once approved by the Congress. As a general rule, no, OMB would not become involved in an individual case, nor request a determination from the IRS.

I would like to mention, and I think this is important, although I don't know what the trends are today. Historically, leasing has not accounted for more than about 1 percent of total procurement funds. I think if there are trends, we ought to try to pick out what those are. It will help us make better judgments on what kind of procedures ought to be set up.

We are not opposed to changing our procedures, changing the discount rates or doing whatever is necessary to see that we have good business practices.

Mr. PICKLE. I am sure you are not, Mr. Sowle. But I am disturbed that no one in the Government has asked for a ruling—if this is a good lease contract or not. I had assumed that opinion had been asked and we were expecting a ruling.

Chairman RANGEL. Would the gentleman yield?

Mr. PICKLE. It is too much a hot potato and they just don't do anything about it.

Mr. SOWLE. The Department of Defense is responsible for its own contracts, within the ground rules laid out. We certainly wouldn't try to interfere. In fact, in my case, I am specifically precluded by statute from interfering.

Chairman RANGEL. Mr. Pickle, let me ask this. Is it Treasury's position that only a taxpayer can request a ruling?

Mr. BALLENTINE. Yes, I think that is correct.

Chairman RANGEL. The Navy is not a taxpayer; right?

Mr. GRANWELL. That is correct.

Chairman RANGEL. And so the Nation stands to suffer, depending on this ruling, a substantial loss, if what the Navy has assumed was valid and legal, is not upheld in the ruling?

Mr. BALLENTINE. Without getting into the details, because these are complex questions, but the issue of the amount of loss is really the obverse side of what we have been talking about elsewhere, about putting this off budget.

If, in fact, the ruling goes negatively, what you do is put the outlays on budget——

Chairman RANGEL. Doesn't this concern OMB at all? We were talking earlier this afternoon about what happens if the IRS rules that this is not really a service contract. The Navy said that it would then have to come back to the Congress and ask for additional funds.

Now they can't even do that without coming to OMB; is that correct?

Mr. SOWLE. As I understand it, this is one of the contingencies in the contract, or proposed contract. And there is no official of the Federal Government who can make a contract without funds available to obligate. If he does, he is in violation of the Anti-Deficiency Act.

Chairman RANGEL. Did not the Navy just do this?

Mr. SOWLE. Sir, I don't know exactly what the Navy has done.

Chairman RANGEL. Has the Navy——

Mr. PICKLE. I am told the Navy has not and that no one has. I am particularly disturbed that it seems that—and Treasury hasn't done anything. Am I not correct in making this observation?

You are not talking about a ruling being asked by a taxpayer. It is an agency question really with respect to the Government.

This is a policy question, a national policy question. This issue is as hot right now as a 5-inch Navy gun on rapid fire. At least in Washington, and perhaps among this blue-suited group here today.

At least it is a very disturbing question for all of us to know what happened about it. Now the Navy has shifted actually some 30 percent of the cost of this deal to the U.S. Treasury and you don't have an opinion on it?

Mr. BALLENTINE. I didn't mean to state that. We were talking about the characterization of particular contracts as to their validity under current law. That is far different from saying whether we have an opinion on an accounting for the full cost of the program.

Indeed, I stated in my testimony my opinion about the general practice of leasing and how to approach that. When we come back to the beginning point raised here about these particular contracts, as I understand it right now, not all the lessors have been named yet. Typically in a ruling in this situation, the lessors would have to be a party to the ruling so not even all the parties are available now to make the ruling.

But that kind of ruling is an interpretation of current law. While there are many policy implications in the broader issue here, we cannot state that the ruling for private taxpayers out there on contracts entered into is other than that, a ruling on current law.

Mr. PICKLE. I just can't believe no one has actually set about trying to do something about this very bothersome question. I particularly can't believe that OMB, who together with Treasury, is supposed to be our watchdog of the Treasury, would not be concerned, and seek a ruling, but would, in effect, not be concerned about the tax expenditures of three-quarters of a billion dollars on one deal.

This is not the concern of the Office of Management and Budget?

Mr. SOWLE. I haven't heard anyone say OMB was not concerned with tax expenditures. However, I have made it very clear, I think,

that we are willing to look into our rules and procedures and see if they need modification.

Mr. PICKLE. Who would be the proper committee to make that inquiry, if the Treasury——

Chairman RANGEL. Why not of Mr. Sowle?

OMB had these circulars that are designed as guidelines, and that none of the circulars required this type of exchange with the Treasury. What would you recommend, assuming now that you do have a concern?

Mr. SOWLE. I think we are in a position where we have got some fact-finding to do to see what we ought to be doing. The circulars have been perfectly legitimate and workable. I think they are fundamentally sound up until this point.

As I pointed out in my testimony, the whole national income accounts, the budget and everything is worked on a pre-tax basis. If we are going to change all around to an after-tax basis, this is a major consideration.

Now, I think, as I have heard here before, there are some recommendations by the group that made the study for the Joint Economic Committee, some alternatives. I think these are the kinds of things we have to take into account and see if we can't come up with a better procedure and policy document.

Mr. PICKLE. Are you taking those things into consideration?

Mr. SOWLE. Absolutely. I pointed that out earlier, Mr. Pickle.

Mr. PICKLE. Are you making a study of this issue now?

Mr. SOWLE. Yes, sir, but not of this particular case. I want to be sure I am not committing us to something we are not doing. We are definitely looking at those two circulars to see how they should be amended or changed.

The results of your inquiry here certainly are going to have an impact on that.

Mr. PICKLE. Mr. Chairman, let me—this has been a long day. I don't think I have any other questions.

I would like to get into the question of residual value and would like both of you to tell me whether you think, after you look at the cases, whether there is a residual value in the ships and in what amount, because the two studies made said there would be no value.

The question is, What is the difference between a sale and lease? Do any of you want to comment on that, or is that for somebody else?

Mr. SOWLE. I would say in a normal lease agreement like this, the value of the remaining property is taken into consideration in the lease itself. Technically, whether it is a sale of property, I don't know.

Mr. PICKLE. Mr. Chairman, I want to conclude by saying this. The leasing question was brought to our committee's attention because it has a very definite potential for budget deficits.

If, indeed, some $58 billion is shifted to the Treasury's budget, that has serious implications in the overall budget. The question is, Is this good tax policy? Nobody has done anything wrong.

Some may have looked the other way and proceeded full steam ahead on the assumption this is good, we will go right ahead. But it does raise serious tax policy questions.

I think from the defense standpoint, it raises serious defense questions. But over and above that are the tax and budget implications of leverage leasing throughout the United States, particularly as it pertains to public entities.

If that is allowed to advance in a major way, the cost of this program would look like peanuts if, indeed, we are establishing a kind of backdoor revenue sharing.

So I think it is a serious question. I don't think the Navy has violated any law, but these are questions we ought to ask ourselves. If we, the Congress, permitted this, we have got to either change it or say that it is the correct policy.

That is what I think we should strive for. I hope that this hearing, Mr. Chairman, will focus on some of these policies and help us get a decision as quickly as possible, including getting a ruling of the IRS.

Chairman RANGEL. I do hope that if there are questions that we didn't ask and you think that you could give some guidance to other Federal agencies, that they would be in a better position to decide whether to buy, to purchase, or to lease, that we might avoid these type of situations where it appears as though our Government is not working very closely together.

In any event, we thank you for the cooperation that you have given to this committee, and I will ask that as we forward our copy of the summary of the testimony and recommendations to the chairman of the full committee that we will send copies to you to see whether or not you have any additions or recommendations that you can make.

Thank you.

Mr. SOWLE. Thank you very much.

Chairman RANGEL. The record will be open until March 18.

The subcommittee stands adjourned.

[Whereupon, at 4:40 p.m., the hearing was adjourned.]

[The following was submitted for the record:]

CHARLES B RANGEL, N.Y., CHAIRMAN
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COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C. 20515

SUBCOMMITTEE ON OVERSIGHT

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COMMITTEE ON WAYS AND MEANS

JOHN J. SALMON, CHIEF COUNSEL
A.L. SINGLETON, MINORITY CHIEF OF STAFF

March 23, 1983

Dr. Alice Rivlin
Director
Congressional Budget Office
U.S. Congress
Washington, D.C. 20515

Dear Dr. Rivlin:

On February 28, 1983, the Oversight Subcommittee of the Committee on Ways and Means held a hearing to review Federal leasing practices. In order to complete the hearing record, I would appreciate receiving any information your office could provide concerning recent trends in municipal leasing. The Subcommittee is particularly interested in determining whether municipal leasing is growing and, if so, the extent of and reasons for such increases and the tax policy issues involved.

I look forward to working with your office on this important matter.

Sincerely yours,

Charles B. Rangel
Chairman

CBR:bkv

TRENDS IN MUNICIPAL LEASING

Report

Prepared at the Request of
Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives

May 1983

Congressional Budget Office
Congress of the United States

This report was prepared by Pearl Richardson of the Tax Analysis Division, under the direction of James M. Verdier. Questions regarding the analysis may be addressed to her at 226-2680.

INTRODUCTION AND BACKGROUND

In the past few years, leasing has become an increasingly important municipal financing tool. Municipal leases take many forms and frequently substitute for tax-exempt bonds. The most common alternatives to long-term general obligation bonds are tax-exempt leases and sale-leasebacks.

Tax-exempt leases provide for the municipal purchase of property or equipment under an installment sales contract calling for periodic payments of principal and interest. The interest payments are exempt from federal taxation. Local governments use tax-exempt leases to buy all kinds of equipment, from typewriters to school buses, and, to a lesser extent, real property.

Sale-leaseback agreements make it possible for local governments and other nontaxable entities to benefit from tax deductions normally available only to the private sector. Under these agreements, a local government or a tax-exempt institution sells real property to private investors and simultaneously leases it back. The private entity puts equity into the property and in return gets rental payments and the tax benefits of ownership, which include interest deductions, depreciation deductions and, occasionally, investment tax credits. These tax benefits are generous and can be passed on to the lessee in the form of lower rental payments. Sale-leasebacks work for all manner of facilities, from college campuses to city halls, and their use is growing.

In general, the trend in municipal financing has been away from traditional general obligation bonds and toward mechanisms that make it possible to avoid seeking voter approval and to raise funds without being subject to established debt limits. The growth in the use of revenue bonds and, more recently, innovations in municipal leasing are manifestations of the search for new funding sources. So far, the growth in municipal leasing has been difficult to document with any precision. Although anecdotal information on individual projects is easy to come by, hard data on leasing activity nationwide are unavailable. As a result, it is impossible to measure the effect of municipal leasing on federal revenues. Although leasing is often a substitute for tax-exempt bond financing, it may sometimes lead to borrowing that would not otherwise occur and therefore to higher revenue losses. Since the availability of alternative financing is conjectural, increased revenue losses are very difficult to estimate.

From the standpoint of tax policy, the growing use of sale-leasebacks is a significant development. Local governments now have a much stronger incentive to sell public property to private parties than in the past. The incentives are much stronger because of the more liberal depreciation allowances and investment tax credits permitted under the Economic Recovery Tax Act of 1981 (ERTA).

The attractiveness of sale-leaseback arrangements appears to be an unintended effect of ERTA, which, in time, could have negative effects both on resource

allocation and on federal revenues. At present, private entities are buying public buildings primarily to benefit from tax deductions: without the incentives in current tax law, these investments would be unlikely to occur. The costs involved in many sale-leasebacks include the federal revenues foregone from issuing tax-exempt industrial revenue bonds (IRBs) to finance property acquisition and rehabilitation, and the value of depreciation deductions and investment tax credits. In most cases, sale-leasebacks are less costly to municipalities than issuing general obligation bonds. For the federal government, however, municipal sale-leasebacks at times may be more costly, since the revenue loss from accelerated depreciation and investment tax credits may exceed that from tax-exempt bonds. Institutions without the authority to issue tax-exempt debt may also conclude sale-leaseback arrangements. In these instances, the revenue loss to the federal government is even greater, since the sale-leaseback may be taking the place of taxable rather than tax-exempt financing.

Use of Leasing by Tax-Exempt Entities

Tax incentives, such as accelerated depreciation and investment tax credits, were designed to benefit only taxable entities. Sale-leasebacks provide a way for nontaxable entities to benefit from tax incentives. The safe-harbor leasing provision, enacted in 1981 and repealed the next year, also would have extended tax incentives to nontaxable firms by allowing them, in effect, to sell tax breaks they were unable to use to firms with enough tax liability to use them. Safe-harbor leasing was intended to provide equal investment incentives to firms with different tax liabilities but similar investment opportunities. The rationale for it was that firms with sufficient tax liabilities to offset all of their credits and deductions had a comparative advantage over others because they could afford to make less productive investments than firms with little or no tax liability would be likely to make. In theory, safe-harbor leasing established a level playing field for both kinds of firms, allowing the productive value of the investment itself to determine whether it would be made. In practice, safe-harbor leasing seemed to improve the neutrality of investment incentives when used by firms that expected to be nontaxable for temporary periods and to have the opposite effect when used by firms that expected to be nontaxable for long periods.[1] An assumption underlying safe-harbor leasing was that sooner or later income from profitable investments would offset tax deductions so that tax revenues would flow back to the federal government. In the case of municipalities and tax-exempt institutions, however, the benefits that indirectly flow to them from leasing are never offset by profits and never have to be paid back. When nontaxable entities can benefit indirectly from depreciation deductions and investment tax credits, they have an advantage over taxable entities in the

1. Analysis of Safe-Harbor Leasing, a report prepared by the Staff of the Joint Committee on Taxation for the Committee on Ways and means, U.S. House of Representatives, and the Committee on Finance, U.S. Senate, p. 34.

competition for investment resources. In permitting safe-harbor leasing of mass transit commuting vehicles for governments and public transportation authorities, the Congress clearly intended to give certain nontaxable entities such an advantage.[2] But whether the Congress intends that advantage to exist in other situations is an open issue.

The prevalent practices in municipal leasing are described in more detail below.

TYPES OF LEASING AND THEIR USES

Operating Leases

Operating (or true) leases are arrangements in which the lessee acquires use, but not ownership, of property for a term that is shorter than the asset's useful life. Lease terms are often only a year, and the property belongs to the lessor both during and upon expiration of the lease. Under current law, a nonexempt lessor must pay income taxes on the lease or rental payments. If the lessee is a governmental unit, the lessor may claim some, but not all of the benefits of ownership. Specifically, depreciation deductions are permitted, but the investment tax credit is not available unless the property involved is an old or historic building that has been substantially rehabilitated. This extension of the investment tax credit to old or historic buildings in 1981 made operating leases more attractive, although state and local governments have used operating leases for many years for a wide variety of property and equipment.

Tax-Exempt Lease-Purchase Arrangements

Growth and innovation in municipal leasing have largely been confined to tax-exempt lease-purchase arrangements and sale-leaseback agreements. In contrast to operating leases, lease-purchase agreements are essentially installment sales contracts providing for the acquisition of property by a governmental entity. Under the contract, the governmental unit makes periodic payments representing installments of the purchase price of the property plus interest. At the end of the contract term, the governmental unit will own the property or will acquire it for a nominal sum.

Tax-exempt lease-purchase agreements have to satisfy state and federal legal requirements that on the surface appear to conflict. From the standpoint of state law, the lease-purchase contract cannot constitute debt. For purposes of federal tax law, however, the contract must be an "obligation" of a governmental unit within the

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2. Economic Recovery Tax Act of 1981, Section 201.

meaning of Section 103 of the Tax Code. Accordingly, if the contract is an obligation of a governmental unit and is structured as an installment sale, rather than as a true lease, the interest portions of the payments will be exempt from federal taxation.

Since most states prohibit the obligations of a governmental unit under the lease-purchase contract from being subject to debt limitations, most tax-exempt leases have a so-called "non-appropriation" clause, which provides that the obligation of the governmental unit to continue making payments under the contract is subject to annual appropriation. This clause avoids having the agreements classified as long-term debt under state law and allows the governmental unit to terminate a lease without penalty, except for loss of the property, if the necessary funds are not appropriated. Vendors, or lessors, protect themselves from non-appropriation by charging a higher interest rate than for debt backed by the general obligation of the issuing authority and by including in the contract a clause prohibiting the governmental unit from leasing or purchasing replacement equipment for a specified time.

Uses. Tax-exempt leases have been used to acquire many kinds of equipment, from fire trucks to computers, and to a lesser but growing extent, to finance buildings and other real property. Typical transactions last from two to seven years, based on the useful life of the property, and tend to be for less than $1 million. The average lease is in the $100,000 to $200,000 range. Some recent transactions, however, have been much larger and for much longer-lived assets. These include:

- A $3.5 million police station in Los Angeles, which the city will purchase for a nominal sum at the end of the ten-year lease;

- A $34 million lease financing to fund a telephone system for San Diego County, California;

- A $54 million lease financing for new parking facilities in Anaheim, California;

- A $30 million jail and a $28.6 million school building program in Jefferson County, Colordao;

- A $23 million pier on the Columbia River for the Port of Portland, Oregon.

Financing. The financing of lease-purchase contracts depends on the size of the transaction. For smaller transactions, financing is usually provided by a single bank, insurance company, or wealthy investor. Smaller leases typically are privately placed, with a lease financing company or securities firm acting as intermediary. Larger transactions generally involve a number of investors who acquire rights to receive installment payments through certificates of participation in the lease-purchase contract. In these instances, a securities firm will underwrite a public offering or a limited placement to institutional investors. Certificates of participa-

tion, which are generally issued in units of $5,000, make it possible to market a lease financing to a large pool of investors in a manner similar to municipal bond offerings. If the offering is public, the certificates will be rated and it will be possible to trade them in secondary markets. (Ratings are usually one grade below the general obligation debt of the issuing locality, reflecting the perceived higher risk of the securities.) Privately placed, unrated leases are generally held by the lender.

Benefits and Drawbacks. For investors, leases are a source of tax-exempt income offering a higher rate of return than comparable tax-exempt obligations because of their perceived higher risk. (While purchasers of leases, or participations in them, are prohibited under federal law from taking depreciation deductions or tax credits on equipment or most kinds of property sold to local governments, they can treat the lease income as tax-exempt bond income.)

For municipalities, lease-purchase financing offers several advantages over bond financing. In addition to avoiding full cash outlay for property, it permits governmental units to finance the acquisition of capital goods without any concern about debt limits or any need to appeal to voters for approval to issue bonds. Because leases do not have the backing of the issuing authority, however, interest rates on them are higher than for general obligation bonds of similar size and term. For small transactions, the overall costs of leasing might well be lower than those of bond financing because arranging a privately-placed lease financing is less expensive than issuing bonds to the public. Moreover, lease-purchase agreements have the advantage of gearing the term of the contract to the life of the asset. In many cases, bonds are issued with maturities that far exceed the useful life of the equipment being financed. For large transactions involving certificates of participation, issuing costs are no lower than for bonds. In these instances, leasing is a means of financing capital acquisition without encumbering debt limits. It may also be a means of circumventing state interest-rate ceilings on bonded debt and of avoiding bond issuance procedures.

Volume. The volume of tax-exempt leasing is unknown. Most tax-exempt leases are privately placed, and no record of them exists beyond the local level. In the absence of federal reporting requirements, determining the volume of privately-placed tax-exempt leases would be exceedingly difficult. A few years ago, a similar problem arose with privately-placed small issue industrial revenue bonds. It turned out that enough state agencies imposed reporting requirements on local bond issuance activities to make it possible to arrive at reasonable estimates of the level of activity. So far, checks with selected state agencies have revealed that leasing is generally not subject to reporting requirements. According to Gregory Eden, Chairman of the Association for Municipal Leasing and Finance, tax-exempt leasing in 1982 amounted to about $2 billion, up from $1 billion in 1981. These estimates, which are based on known public offerings and other transactions reported by association members, are acknowledged to be rough. The volume does, however, appear to be increasing significantly.

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Effects on Federal Revenues. In the absence of better estimates of the volume of net new tax-exempt leases, the costs are impossible to determine. Tax-exempt leases are not now included in the tax expenditure budget.

From the standpoint of federal revenues, tax-exempt leases are no different from tax-exempt bonds. Assuming that a project would be funded one way or another, the tax expenditure would be the same regardless of the financing mechanism. To the extent that leasing makes it possible to finance projects that otherwise would not go forward, however, tax expenditures conceivably may be higher, but by amounts impossible to determine with any confidence. In some instances, general obligation financing may be unavailable and leasing may be the only alternative. In other cases, municipalities may have alternative tax-exempt financing mechanisms.

Sale-Leasebacks

Although tax-exempt lease-purchase agreements are more prevalent, sale-leasebacks raise many more tax policy issues. Under sale-leaseback arrangements, a local government or tax-exempt institution sells public property to a private entity and simultaneously leases it back. The private entity makes an equity investment in the property and in return gets the benefits of ownership, which minimally include depreciation deductions. The local government or tax-exempt institution--such as a university, foundation, or church--gets a cash payment and an opportunity to lease back the facility at a reduced rate reflecting the owner's tax benefits. In order to meet IRS requirements, the nonprofit lessee cannot negotiate a repurchase price for the property in advance or buy the property back for less than its fair market value. The private entity must have a 20 percent minimum "at risk" investment in the project, and the lease has to generate income independent of the tax benefits.

Most sale-leaseback arrangements involve the rehabilitation of existing property or the construction of new facilities. Typically, sale-leasebacks involve at least four primary participants: a municipality, county, state, or tax-exempt organization, which owns and will subsequently lease back the property; a private equity investor; an underwriter, or lender; and a public authority, which will issue tax-exempt industrial revenue bonds to finance acquisition and construction costs.

Under ERTA, sale-leaseback arrangements have become much more attractive, largely because depreciation recovery periods are now shorter for most classes of property than they had been under previous law. In addition, ERTA also provides generous investment tax credits for the rehabilitation of buildings over 30 years old or of historic significance. With the exception of these older buildings, the investment tax credit is generally not available for assets used by governmental entities. If, however, the private entity enters into an operating lease with the owner for the provision of services, the investment may qualify for the credit. To date,

these types of arrangements at the municipal or county level have been confined to sewer and solid waste disposal systems.

Uses. So far, sale-leasebacks have been used or are being considered for convention centers, educational facilities, sewer and solid waste disposal systems, wastewater treatment plants, and all manner of public buildings from libraries to museums to city halls.

Sale-leaseback transactions are generally quite complex, and although not many have actually been completed, the numbers are growing. Probably the most widely publicized deal has been the sale of the City of Oakland's Museum and Auditorium. The museum was immediately leased back to the city, and the auditorium was rehabilitated for use as a convention center extension and subsequently leased back. Total financing amounted to $22 million for the museum and $20 million for the auditorium plus the costs of renovation. The expansion of a library in Sunnyvale, California, was financed under a similar arrangement. The City of Atlanta is reportedly considering a sale-leaseback to finance the rehabilitation of its city hall. The City of Norfolk, Virginia, recently did so; debt financing came from a $3 million industrial revenue bond. Many municipalities are looking into sale-leasebacks, particularly for historic structures. So are tax-exempt non-profit institutions, particularly universities. Transactions that are now under way or have been recently completed include:[3]

- The $6.3 million Pantages Center for the Performing Arts in Tacoma, Washington, that was rehabilitated with a combination of funds from the federal government, the state, and private contributors. Federal funding included a $1.5 million grant from the Economic Development Administration. Since EDA's regulations prohibited sale or lease of the property without the permission of the Secretary of Commerce, special legislation was required to make the leaseback possible. In December 1982, the Congress passed a rider to EDA's continuing resolution permitting the lease. Over a six-year period, the performing arts center will bring the city $1.72 million in cash from the equity investors. The city will invest the funds and, beginning in the seventh year, use the earnings to defray the operating costs of the theater, which are now running at $90,000 annually, and to pay net annual lease fees of $83,000 to the purchaser. A portion of the equity investment will also be used to set up a fund for the repurchase of the

3. Sources of information on these transactions include The Weekly Bond Buyer (August 16, 1982, and April 18, 1983); The Washington Post (April 20, 1983); Urban Conservation Report (April 15, 1982, October 18, 1982, March 31, 1983, and April 15, 1983); Resources in Review (November 1982); and telephone interviews with attorneys, syndicators, financial consultants, investment bankers, and local officiofficials.

when the lease expires at the end of 35 years. The building, which dated back to 1913, was located in an urban renewal area and listed on the National Register of Historic Places. Consequently, the equity investors will benefit from a 25 percent investment tax credit. The city is now giving preliminary consideration to the leaseback of a $44 million sports and convention center.

- In Seattle, Washington, the Pike Place Preservation and Redevelopment Authority has arranged three leasebacks. Two were completed before the passage of ERTA. The third was a $4 million rehabilitation of an historic building, Stewart House, that was developed into a mixed-use project with retail space on the ground level and both low-income housing for the elderly and single-room occupancy units on the upper stories.

- Bennington College is arranging to lease its 650-acre campus from private investors. According to the Washington Post (April 20, 1983), the college will receive the cash necessary to pay off a $2.5 million bank loan and will be able to pay the investors back over a 20-year period.

- Towson State University in Towson, Maryland, arranged a sale-leaseback to finance the construction of new dormitories. A test case involving the sale-leaseback of a training facility for restaurant workers in Baltimore had previously established that such transactions do not violate the state prohibition against borrowing without voter approval.

- The University of Nevada is considering a sale-leaseback for two new basketball pavilions. According to the Weekly Bond Buyer (April 18, 1983), "the two pavilions could be sold for about $60 million and the university would lease them back for 55 years through a $17 million tax-exempt bond issue. The arrangement . . . would provide the university with $1.5 million in operating funds for five to seven years."

- The City of Alexandria, Virginia, is selling its Torpedo Factory arts center for $4.5 million to a limited partnership. Financing for the project will come from a $2.5 million industrial revenue bond; an equity payment at about $1.0 million from the limited partners; and a second mortgage of about $1.0 million held by the city. The city will lease back the space for sublease to local artists.

- The Southwest Sewer District of Suffolk County, New York, plans to sell its sewer system to private investors for $811 million; of that amount, about $650 million will come from the sale of industrial revenue bonds. In this case, the county will enter into an operating lease with the owners for provision of sewer services. The limited partners presumably will be able to claim both depreciation deductions and an investment credit for the property. A number of legal issues remain to be resolved before the project

can go forward. At present, the transaction is expected to be completed some time in the fall of 1983.

Benefits and Drawbacks. For private equity investors, the benefits of sale-leaseback arrangements lie primarily in the tax shelters made possible by depreciation deductions and by investment tax credits, where available. In addition, lease payments made by the municipality provide a continuous rental income stream. (The rental income is fully taxable and, as such, differs substantially from payments made under lease-purchase agreements.) If industrial revenue bonds are used to finance acquisition and rehabilitation costs, investors in them will benefit from tax-exempt income. (Under current law, the equity investors cannot hold the IRBs; if they did, the bonds would be taxable.)

For municipalities, sale-leaseback arrangements provide a means of raising funds for capital improvements that may be less costly than issuing general obligation bonds. The lower costs result from the combination of the returns on the equity payments made by the private investors and the portion of tax benefits that private investors will pass on to the municipality in the form of lower rental fees.

Sale-leasebacks usually involve lengthy negotiations. Not the least of the problems that have to be considered are arrangements for the local government to repurchase the property when the lease expires. Generally, a lease will run for between 15 and 35 years, and thereafter the local government will have options to renew it if it cannot arrive at an acceptable purchase price. The repurchase price cannot be negotiated in advance; however, since the local government will usually retain ownership of the land, it will have some flexibility at the end of the initial lease period.

Effects on Federal Revenues. The effects of sale-leasebacks on federal revenues have so far been minimal. Potentially, however, they may be a vehicle both for off-budget revenue sharing with local governments and for providing subsidies to nontaxable institutions.

Essentially, one of the effects of current tax law has been to provide incentives for nontaxable entities to give up ownership of property and productive facilities and for private entities to make investments based primarily on tax considerations. The tax losses, if any, depend on the nature of the transaction. Assuming that a municipal sale-leaseback takes the place of tax-exempt financing that would otherwise occur and that the private investors borrow funds at conventional rates, any net losses to the federal government would be limited. The savings from not issuing tax-exempt municipal bonds would largely offset the revenues forgone from the equity investors' depreciation deductions. More typically, however, sale-leasebacks involve the issuance of tax-exempt industrial revenue bonds to finance property acquisition and rehabilitation. In these instances, the tax losses are substantially greater than those resulting from general obligation financing because they include the revenues forgone from issuing IRBs, coupled with the value of depreciation deductions and, in

some cases, investment tax credits. As an example, suppose a city government wished to rehabilitate its 50-year old city hall at a cost of $4 million. The city could either issue general obligation bonds or enter into a sale-leaseback agreement with a private partnership. If the private developer's acquisition and renovation costs were financed with tax-exempt IRBs, a sale-leaseback could cost the city less, and the federal government more, than rehabilitating the building with the proceeds of a general obligation bond issue. Under the sale-leaseback, the city would have to pay rent to the lessor and, 20 to 30 years later, repurchase the building at its fair market value. In the meantime, the city would benefit from the equity payment it received from the partnership, which it could invest in high-yielding securities, and from reduced rent payments, which would flow from the lessor's depreciation deductions, interest expense savings, and rehabilitation tax credits. Over a 20-year lease term, the present value of the net costs to the federal government of these benefits would be $2.6 million. By comparison, if the city floated general obligation bonds, the federal government would incur costs of about $1.1 million. Although the difference would not show up as a line item in the federal budget, the city government would nevertheless benefit from additional subsidies that effectively reduced its financing costs below the level of general obligation funding, and the private investors would benefit from generous tax writeoffs.[4]

When such nontaxable entities as universities engage in sale-leasebacks, the result may be an even greater net drain on federal revenues. These institutions often use tax-exempt debt for physical plant. But if a university sells and leases back its campus and uses the equity payment to set up an endowment or a scholarship fund, it benefits from federal subsidies for accelerated depreciation, while the federal government receives no offsetting saving from forgone tax-exempt bond financing.

Safe-Harbor Leases

Safe-harbor leasing was designed primarily for private-sector transactions. With the passage of ERTA, governmental entities have been able to take advantage

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4. These calculations assume 20-year tax-exempt financing at 9.4 percent, an alternative taxable rate of 12.0 percent, and a discount rate of 10 percent. They also assume, for the renovated structure worth $5 million, a 20 percent rehabilitation tax credit, a full basis adjustment, 15-year straight-line depreciation for the building and improvements, and 5-year straight-line depreciation for equipment. Of the $4.2 million in depreciable property, $3.9 million is for the building and $0.3 million is for equipment. The costs to the federal government represent after-tax dollars and are offset by the net revenues generated from the rental income of the lessors, estimated at $400,000 a year for 20 years. The net rental income consists of lease payments minus interest deductions. (The city pays maintenance and operations costs.) The investors are assumed to be in the 50 percent marginal tax bracket.

of safe-harbor leasing for mass transit rolling stock vehicles financed completely or partially with tax-exempt bonds. Generally, a transit authority or local government purchases the rolling stock and sells it to a private firm. The firm, which benefits from depreciation deductions, then leases the equipment to the local government at a rate that reflects its tax savings. Several public transit authorities have negotiated such leases. In this instance, the Congress chose to extend tax benefits to transactions involving local governments and transit authorities in order to reduce the cost of public mass transit equipment. The Tax Equity and Fiscal Responsibility Act of 1982, which repealed safe-harbor leasing generally as of January 1, 1984, extended its use for mass transit vehicles until January 1, 1988.[5]

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5. Tax Equity and Fiscal Responsibility Act of 1982, Section 208.

Congress
of the
United States
House of Representatives

BRIAN DONNELLY
MASSACHUSETTS
ELEVENTH DISTRICT

COMMITTEES:
BUDGET
MERCHANT MARINE
PUBLIC WORKS AND TRANSPORTATION

March 16, 1983

The Honorable Charles Rangel
Chairman of the House Subcommittee on Oversight
1101 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Rangel:

I would appreciate the insertion of my attached statement into the hearing record and transcript of your Subcommittee's February 28th hearing on Navy Leasing.

While I was unable to attend the hearing, and offer my testimony in support of the Navy's TAKX construction and conversion program, I would greatly appreciate your taking the time to consider my views in any further deliberations on this matter of mutual concern.

Thank you very much for your kind attention to my request.

With warm regards, I am

Sincerely,

BRIAN DONNELLY
Member of Congress

BD/gl/enc.

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Washington
1-800-424-9112

Statement of Congressman Brian Donnelly to be entered into the record of the House Ways and Means Subcommittee on Oversight's hearing of February 28, 1983.

Chairman Rangel and distinguished members of the Subcommittee on Oversight, I welcome and appreciate the opportunity to express my strongest support for the Navy's TAKX ship construction and conversion program.

I could center my remarks on our country's well-recognized need for vastly upgraded sealift capability, and the alarming decline in America's maritime strength most vividly evidenced by the idle state of our commercial shipyards.

The TAKX Maritime Prepositioning Ships will fulfil an urgent requirement for seaborne transport of equipment, fuel, and supplies for our Rapid Deployment Forces. Timely delivery of the thirteen TAKX vessels to the Navy will go a long way toward enhancing currently-lacking sealift mobility and seapower projection.

While improving the Armed Forces ability to respond quickly and effectively to trouble spots around the world, the TAKX program meets another vital national need, that of maintaining an adequate, geographically-dispersed shipbuilding mobilization base. This program comes at a very critical time in the life of the U.S. maritime industry. The program has permitted the survival of a very valuable part of the industrial base. It is my understanding that at its height, the Navy's TAKX construction and conversion program will provide or maintain over 9600 shipyard jobs at the 4 yards involved. This represents 14% of the current employment level in the active shipbuilding base. It can mean the difference between sustaining or possibly losing elements of the shipbuilding base, which is now considered at a minimum level for supporting national security requirements.

To bring this matter, and the Navy's TAKX program, closer to home, let me tell you what the TAKX award means to the people I represent who live in the 11th Congressional District of Massachusetts.

The Quincy General Dynamics Fore River Shipyard is the largest employer in my district. The last five years have brought massive layoffs at the yard, and great distress to the many affected families. Until the recent award for construction of five TAKX vessels, it appeared layoffs were going to accelerate to a point where the shipyard's future operations would be in serious doubt. The TAKX contract award by the Navy came along at just the right time, and it now appears that up to 5000 workers will be employed at the Quincy shipyard for the next few years. The beneficial impact of the contract on firms and shops that supply and service the yard will be felt for years to come.

As the Subcommittee reviews the tax aspects of the Navy's TAKX program, I only ask that in your deliberations this Subcommittee keeps in mind the very real economic relief and enhanced job security this program means for many, many American workers and their families.

DUNCAN L. HUNTER
48TH DISTRICT, CALIFORNIA

COMMITTEE ON ARMED SERVICES

SUBCOMMITTEES:
MILITARY PERSONNEL AND COMPENSATION
PROCUREMENT AND MILITARY NUCLEAR SYSTEMS

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Congress of the United States
House of Representatives
Washington, D.C. 20515

March 16, 1983

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Ways and Means
Subcommittee on Oversight

The Honorable Charles B. Rangel
Chairman
Ways and Means Subcommittee on Oversight
U. S. House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

Enclosed is a statement on the Navy's plan to charter TAKX ships for the Military Sealift Command that I would like to be made a part of the official record per the Subcommittee's hearing on Federal Leasing Practices on February 28, 1983.

As I state in my testimony, the TAKX ship charter is an essential program that must be supported. While there may be some legitimate questions about the methods by which government agencies put together cost studies on leasing versus purchase, we should not lose sight of the goals of the TAKX program.

If I can answer any further questions you may have, please feel free to contact me.

With best wishes.

Sincerely,

Duncan Hunter
Member of Congress

DH/gm

Statement of Congressman Duncan Hunter before the House
Ways and Means Subcommittee on Oversight

Mr. Chairman and Members of the Subcommittee on Oversight:

As a Member of the House Armed Services Committee, I have a very strong interest in seeing the successful completion of the TAKX program. Furthermore, it may interest the Committee to know that I am a Member of the Seapower subcommittee, and in the 97th Congress was a Member of both the Procurement Subcommittee and the Special Panel on Defense Procurement Procedures of the Armed Services Committee. As a Member of these subcommittee's I have paid close attention to ensuring that our military acquires equipment at the least possible cost.

Currently there is some degree of controversy about the true costs of the Navy's plan to lease the 13 TAKX ships rather than buying these ships outright. I am no tax expert and do not plan to get involved in the specifics of which method of acquiring the ships is cheaper. I will point out, however, that the Navy's plan has been fully studied by the Administration, outside consultants, and Congressional committees. The leasing plan had the approval of both the Secretary of Defense and the Office of Management and Budget. In addition, the Committees on Armed Services and on Appropriations of the Senate and the House all provided written concurrence with the Navy proposal.

The Navy claims that they will save a net amount of $28.4 million per ship. The Joint Committee on Taxation's study, however, claims a net loss of $20.8 million per ship. There are some who have jumped to the conclusion that the Navy is engaged in a dishonest or inept attempt to gain Congressional approval of a poorly thought out plan. This is

simply not true. In talking to committee staff and in studying the details of the plan, it appears to me that the differences in these two estimates spring from differing assumptions. I would like to emphasize that these differing assumptions are reasonable differences between reasonable men.

I would also caution the Members of this Committee about considering the cost of the TAKX ships by themselves without regard to current Navy operational requirements. Leasing ships that have already been built to commercial standards seems to me to be cheaper than acquiring the ships through the normal military procurement process. At least part of the savings will be realized by receiving the ships about two years before they could be if they were built to order, which was one seriously considered option. Assistant Secretary of the Navy George Sawyer in testimony given to the Readiness Subcommittee of the House Armed Services Committee on September 17, 1982, stated that their charter plan would result in delivery of the ships two years ahead of their original schedule. This would allow them to phase out seven ships currently stationed in the Indian ocean at an annual savings slightly in excess of $100 million.

It is very easy to get lost in the examination of the details of leasing or purchasing. We cannot look at the acquisition of the TAKX ships in isolation from the urgent requirements that they are designed to meet. When the Rapid Deployment Force was formed it was very evident that there was a serious shortfall in sealift. This lack of sealift capability threatens to undermine the entire RDF.

It was for this reason that the Navy formulated a plan to field a Maritime Prepositioning Force (MPF) to provide sealift support to the

RDF. The MPF will be comprised of 13 TAKX ships which will be prepositioned in the Indian Ocean in order to provide equipment, supplies, ammunition, and fuel on a standby basis to the U.S. Marines. Should a conflict develop, Marine Amphibious Battalions would be airlifted to the trouble spot, meet up with the eqipment on the prepositioned TAKX ships, and proceed to the objective area.

In addition to providing absolutely vital support to the Rapid Deployment Force, the TAKX plan provides valuable support for the shipbuilding industrial base of the United States. During his campaign for the presidency, President Reagan said that the "shipbuilding industry is vitally important to our nation." The President continued:

> "Should our shipbuilding capability continue to decline, America's mobilization potential will be seriously undermined because a large reduction in a skilled shipbuilding workforce today makes any increase tomorrow very difficult. This is a dangerous threat to our national security, jobs, and a key U.S. industry.
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> ...We must now take corrective action to make certain our merchant fleet and our shipbuilding industry survive and grow."

At a time when the U.S. shipbuilding industry is increasingly threatened by nationally subsidized foreign shipbuilders, the Navy's decision to charter U.S.-built ships will reaffirm the President's commitment to revitalize the shipbuilding industry and to rebuild the industrial base of this nation.

In my own home area of San Diego, the ship repair and shipbuilding industry is experiencing severe rates of unemployment. The local industry is faced with the prospect of 60% unemployment by spring. The loss of

the TAKX program would add an average of 1700 workers over 20 months to these already dismal unemployment figures. The loss of the TAKX program would represent a serious blow to our national security in more than one way.

If the Navy had proceded with a plan to purchase these ships we would be faced with a delay of two years compared with the delivery schedule involved in the charter plan. For two additional years the RDF would be a significantly less effective fighting force. A two year delay would also result in disaster for our shipbuilding industrial base. As the President said, "a large reduction in a skilled shipbuilding workforce today makes any increase tomorrow very difficult." When these serious national security implications are considered against the question of whether it is is cheaper for the Navy to buy or lease the TAKX ships, a question whose answer depends on choosing between reasonable assumptions, I think it is clear that the Navy's current plan must be supported.

I think that this plan to charter the TAKX ships has been carefully crafted by the Navy. Particular credit should go to Assistant Secretary of the Navy George Sawyer, and the Commander of Naval Sea Systems Command Admiral Earl B. Fowler. These two men are excellent public servants and this nation owes both of them a debt of gratitude for their efforts to develop the seapower that is critical to this nation's defense.

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